84-104 (1)

No.

IN THE

Supreme Court of the United States

OCTOBER TERM 1984

RUSSELL REDHOUSE, JR.,

PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT

Petition for a Writ of Certiorari to the
United States Court of Appeals for the
Ninth Circuit

ZAYLE A. BERNSTEIN
JACK STEIN
COUNSEL FOR PETITIONER
BERNSTEIN, BERNSTEIN & STEIN
1164 East Oakland Park Boulevard
Fort Lauderdale, Florida 33334
(305) 563-3205

10 pp

QUESTIONS PRESENTED

1) Whether the Commissioner of Internal Revenue, in amending a Treasury Regulation, is exempt from the requirements of the Administrative Procedure Act § 553 (5 U.S.C. § 553) by operation of IRC § 7805(b).

2) Whether § 7805(b) of the Internal Revenue Code of 1954, as Amended (26 U.S.C. § 7805(b)), provides the Commissioner of Internal Revenue with the unlimited authority to retroactively apply treasury regulations notwithstanding noncompliance with the notice requirements of APA § 553(d) and which causes disparity of treatment between similarly situated taxpayers.

3) Whether the United States Tax Court exceeded its jurisdiction in exercising Article III judicial powers over constitutional matters appurtenant to the de-

termination of federal tax deficiency which has denied the taxpayer his rights to due process of law.

TABLE OF CONTENTS

VOL. II.

TABLE OF AUTHORITIES

Cases:

Constitution, statutes, and regulations:

1. Administrative Procedure Act

2. Internal Revenue Code of 1954 - 26 U.S.C.

3. Treasury Regulations Under the 1939 Code

4. Treasury Regulations Under the 1954 Code

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1984

No.________________

RUSSELL REDHOUSE, JR., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Counsel of Record, on behalf of Russell Redhouse, Jr., petitions for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals (App. A, Vol II, p. 1) is reported at 728 F. 2d. 1249. The opinion of the United States Tax Court (App. C, Vol II. p. 24) is reported at 79 T.C. 355. (1983).

JURISDICTION

The judgment of the Court of Appeals (App. B, Vol. II, p. 22) was entered on March 20, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. Section 7805[1] of the Internal Revenue Code of 1954, 68A Stat. 917, as amended

---

[1] Citations to provisions of the Internal Revenue Code shall be referred to as "Section" unless otherwise specifically noted.

by § 1906 of Pub. L. No. 94-455, 90 Stat. 1834, codified at 26 U.S.C. § 7805 (1970), provides:

A. Authorization. Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal Revenue.

B. Retroactivity of regulations or rulings. The Secretary may prescribe the extent, if any, to which any ruling or regulation relating to the internal revenue laws shall be applied without retroactive effect.

C. Preparation and distribution of regulations, forms, stamps, and other matters. The Secretary shall prepare and dis-

tribute all the instructions, regulations, directions, forms, blanks, stamps, and other matters pertaining to the assessment and collection of internal revenue.

2. Section 553 of the Administrative Procedure Act, Pub. L. No. 89-554, 80 Stat. 383, codified at 5 U.S.C. § 553 (1970), provides:

A. This section applies, according to the provisions thereof, except to the extent that there is involved--

1) a military or foreign affairs function of the United States; or

2) a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts.

B. General notice of proposed rulemaking shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include--

1) a statement of the time, place, and nature of public rulemaking proceedings;

2) reference to the legal authority under which the rule is proposed; and

3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.

Except when notice or hearing is required by statute, the subsection does not apply--

a) To interpretative rules, general statements of policy, or rules

of agency organization, procedure, or practice; or

b) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

C. After notice required by this section, the agency shall give interested persons an opportunity to participate in the rulemaking through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record

after opportunity to an agency hearing, Sections 556 and 557 of this title (5 USC §§ 556 and 557) apply instead of this subsection.

D. The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except--

1) a substantive rule which grants or recognizes an exemption or relieves a restriction;

2) interpretative rules and statements of policy; or

3) as otherwise provided by the agency for good cause found and published with the rule.

E. Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.

3. The original Treas. Reg. § 1.612-3(b)(3) provided that:

- The payor, at his option, may treat the advanced royalties so paid or accrued in connection with mineral property as follows:

A. As deductions from gross income for the year the advanced royalties are paid or accrued, or

B. As deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid, is sold.

For an exception to this treatment when the payor is a sublessor of coal, see paragraph (b)(3) of § 1.631-3. Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for

the first taxable year in which such amounts are paid or accrued. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with subdivision B of this subparagraph. Any election made under this section is binding for the taxable year for which made and for all subsequent years, and the taxpayer must treat all advanced royalties paid or accrued in all subsequent years in the same manner. This paragraph does not grant a new election. Any taxpayer who made an election under paragraph (e) of § 39.23(m)-10 of Regulation 118 (26 CFR (1939) 39.23(m)-10(e)) or corresponding provisions of prior regulations is, by such election, bound with respect to treatment of such advanced royalties whether paid or accrued before or after December 31,

1953. See Section 7807(b)(2). For additional rules relating to elections in the case of partners and partnerships, see Section 703(b) and the regulations thereunder.

4. The proposed Treas. Reg. § 1.612-3(b)(3) provided that:

> - the payor shall treat the advanced royalties so paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold.

However, in the case of advanced royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the minimum royalty payments as deductions from gross income for

the year in which the minimum royalties are paid or accrued. For purposes of this paragraph, a minimum royalty provision requires that substantially uniform royalty payments be made at least annually over the life of the lease.

For an exception to this treatment when the payor is a sublessor of coal or domestic iron ore, see paragraph (b)(3) of §1.631-3. Every taxpayer who pays or accrues advanced royalties resulting from a minimum royalty provision must make an election as to the treatment of all such minimum royalties in his return for the first taxable year ending after December 31, 1939, in which such minimum royalties are paid or accrued. The taxpayer's treatment of such minimum royalties for such first year shall be deemed to be the exercise of the election. Accordingly, a failure to deduct such minimum

royalties for that year will constitute an election to have all such minimum royalties treated as deductions for the year of the sale of the mineral product in respect of which such minimum royalties are paid or accrued. See Section 7807(b)(2). For additional rules relating to elections in the case of partners and partnerships, see Section 703(b) and the regulations thereunder.

STATEMENT OF THE CASE

On November 12, 1976, Edwin Tunick (hereinafter "Tunick"), as the original general partner of Tennessee Coal Resources (hereinafter "TCR"), entered into a lease agreement with L.D. Rowlette (hereinafter "Rowlette"). Pursuant to such lease, Tunick acquired the rights to mine coal from a mine in Clairborne County, Tennessee, plus other assets.

RUSSELL REDHOUSE, JR. (hereinafter "Petitioner") was a limited partner in TCR, a partnership formed on December 30, 1976.

On or about December 31, 1976, Tunick assigned to TCR his rights under the lease, and TCR in turn paid to Rowlette $650,000 cash and a non-recourse note in the amount of $2,350,000 as a prepaid advance royalty pursuant to the lease.

TCR, thereafter, deducted the $3,000,000 as an advance royalty on its 1976 return. The Commissioner of the Internal Revenue Service (hereinafter "Commissioner") disallowed said deduction because no coal was mined in 1976. The Commissioner relied on the amendment to Treas. Reg. § 1.612-3(b)(3) that stated that advanced royalties are to be deducted from gross income in the year the mineral product is sold.

On October 29, 1976, the Internal Revenue Service issued News Release IR-1687 which announced the forthcoming publication in the Federal Register of a proposed amendment affecting mineral leases entered into on or after October 29, 1976. The Internal Revenue Service also announced the suspension of Rev. Rul. 70-20, 1970-1 C.B. 144 (which allowed advanced minimum royalties to be deducted in the year paid or accrued)

and Rev. Rul. 74- 214, 1974-1 C.B. 148 (which permitted a lump-sum payment to be deductible when paid or accrued).

The proposed amendment was published in the Federal Register on November 2, 1976, which announced that public hearings would be held November 30, 1976, and the last date for the submission of comment was November 23, 1976. The lease herein was executed by Tunick on November 12, 1976. The final version of amended Treas. Reg. § 1.612-3(b)(3) was published in the Federal Register on December 19, 1977, thirteen (13) months after the regulation was proposed. T.D. 7523, 1978-1 C.B. 192. The effective date of the regulation was made retroactive to October 29, 1976. This announcement was accompanied by the publication of Rev. Rul. 77-489, 1977-2 C.B. 177, which revoked Rev. Ruls. 70-20 and 74-214.

On March 28, 1980, the Commissioner issued a Notice of Deficiency to Petitioner asserting a deficiency in Petitioner's federal income tax for the calendar year ending December 31, 1976.

On June 8, 1980, Petitioner filed in the United States Tax Court a petition for redetermination of the deficiency set forth in the statutory notice of deficiency. The United States Tax Court had subject matter jurisdiction of this matter pursuant to Rule 20 of the Rules of Practice and Procedure, United States Tax Court.

The United States Tax Court consolidated Petitioner's case with those of other TCR partners[2] who had filed petitions

---

[2]Cases of the following petitioners were consolidated therewith: Irwin M. Adler and Helene E. Adler, docket No. 5709-80;

On March 20, [illegible], the Commission issued a Notice of [illegible] granting a [illegible] for the [illegible] ending December [illegible].

On June [illegible], [illegible] the United States [illegible] of the [illegible]. The United States [illegible] United States [illegible].

The United States [illegible].

[illegible]

in the United States Tax Court after receiving similar statutory notices of deficiency.

The Tax Court, on August 23, 1982, issued its finding of fact and opinion and held that: the procedure used by the Commissioner in amending Treas. Reg. § 1.612-3(b)(3) complied with the purpose behind 5 U.S.C. § 553(d) of the Administrative Procedure Act (hereinafter "APA")(App. C, infra, 50-51); the Legislative Reenactment Doctrine cannot be applied to bar reasonable amendments to regulations where the change is made only prospectively from the date of the

---

Brent W. Trump and Cheryl A. Trump, docket No. 5710-80; Ronald Glassman and Lenora Rae Glassman, docket No. 5711-80; Stephen L. Nemerofsky and Nina B. Nemerofsky, docket No. 5712-80; Gerald L. Gunderson and Judith C. Gunderson, docket No. 5769-80; Sherwin Ross and Marlynn Ross, docket No. 5771-80; Roman M. Wenzel and Emily A. Wenzel, docket No. 5772-80; Wilbur F. Helmus, Jr., and Patricia Helmus, docket No. 5773-80.

[illegible]

[illegible]

[illegible]

[illegible]

announcement of the proposed change by the Internal Revenue Service in News Release IR-1687, published in the Wall Street Journal. (App. C, infra, 52-53). The Tax Court further held that retroactive application of amended Treas. Reg. § 1.612(b)(3) was not an abuse of discretion by the Commissioner under § 7805(b) of the Internal Revenue Code (App. C, infra, 51-53). The Tax Court entered a decision against Petitioner on March 17, 1983 (App D., infra, 68). However, in the Tax Court's findings of fact, it held that the transaction had economic substance and purpose and was not just for the mere avoidance of taxes. (App. C, infra, 32-33).

Petitioner, pursuant to 26 U.S.C. § 7482, filed a Notice of Appeal to the

United States Court of Appeals for the Ninth Circuit on June 6, 1983.[3]

The Ninth Circuit, on March 20, 1984, affirmed the decision of the Tax Court and held that the retroactive application of Treas. Reg. § 1.612-3(b)(3), T.D. 7523, 1978-1 C. B. 192 was not an abuse of the Secretary of Treasury's discretion under Section 7805(b) (App. A, infra, 5-11). The Court also stated that the 30-day notice requirement of 5 U.S.C. § 553 was not applicable to the treasury regulation since it was an interpretative regulation (App. A, infra, 13-16). Finally, the Court rejected Petitioner's arguments that the Tax Court lacked subject matter jurisdiction to decide whether the regulation complied with the APA and that

---

[3]The remaining TCR partners filed a Notice of Appeal in the United States Court of Appeals for the Eleventh Circuit on June 8, 1983; docket no. 83-5543.

the exercise of the judicial power of the United States Government through the ruling by the Tax Court on such regulation constituted a deprivation of due process on the basis that these issues were improvidently raised. The Ninth Circuit held that the Tax Court had jurisdiction to determine the correct amount of any deficiency owed by Petitioner and therefore was allowed to determine whether or not the tax statutes, regulations and rules are valid (App. A, infra, 17-18). The Ninth Circuit permitted an Article I Administrative Court to determine the compliance or lack of compliance by the Internal Revenue Service with the APA.

the exercise of the judicial power of the United States Government through the ruling by the Tax Court on such regulation constituted a deprivation of due process on the basis that these issues were improvidently raised. The Ninth Circuit held that the Tax Court has jurisdiction to determine the correct amount of any deficiency owed by Petitioner and therefore was allowed to determine whether or not the tax statutes, regulations and rules are valid (App. A, infra, 17-18). The Ninth Circuit permitted an Article I Administrative Court to determine the compliance or lack of compliance by the Internal Revenue Service with the APA.

REASONS FOR GRANTING THE PETITION

1. THE NINTH CIRCUIT IMPROPERLY EXEMPTED THE INTERNAL REVENUE SERVICE FROM THE NOTICE REQUIREMENT OF THE APA, REQUIRING THIS COURT'S REVIEW

Congress, by enactment of the APA, established the procedure which all government agencies must follow when engaging in rulemaking. Specifically, Section 553 of the APA provides that all government agencies must publish a notice of proposed rulemaking in the Federal Register, provide interested persons with an opportunity to participate in the rulemaking, incorporate in the rulemaking a concise statement of the basis and purpose of the proposed rule, and publish a substantive rule in the Federal Register 30 days before its effective date. The latter requirement does not apply to substantive rules which grant or recognize an exemption or reserve a restriction, to interpretative

REASONS FOR GRANTING THE PETITION

I. THE NINTH CIRCUIT IMPROPERLY EXEMPTED THE INTERNAL REVENUE SERVICE FROM THE NOTICE REQUIREMENTS OF THE APA, REQUIRING THIS COURT'S REVIEW

Congress, by enactment of the APA, established fair procedures which all government agencies must follow when engaging in rulemaking. Specifically, Section 553 of the APA provides that (1) government agencies must publish a notice of proposed rulemaking in the Federal Register, provide interested persons with an opportunity to participate in the rulemaking, incorporate in the rules adopted a concise statement of the basis and purpose of the proposed rule, and publish a substantive rule in the Federal Register 30 days before its effective date. The latter requirement does not apply to substantive rules which grant or recognize an exemption or relieve a restriction, to interpretative

rules and statements of policy, or for good cause found and published with the rule.

The Ninth Circuit, in holding that § 553(d) of the APA was not applicable to the case Sub judice, concluded that it was doubtful that the Commissioner, in amending or adopting a treasury regulation, was required to comply with the 30-day notice requirement of § 553(d). (App. A, infra, 15). Further, the Court stated that the amendment at issue here falls under the category of being an "interpretative rule". (App. A, infra, 15-16).

The Ninth Circuit's decision in this case, for the first time, initiates a precedent for any government agency to apply its regulations to avoid the procedures mandated by Congress in the APA.

rules and statements of policy, or for good cause found and published with the rule.

The Ninth Circuit, in holding that § 553(d) of the APA was not applicable to the case sub judice, concluded that it was doubtful that the Commissioner, in rescinding or granting a temporary regulation, was required to comply with the 30-day notice requirement of § 553(d). (App. A, infra, 15). Further, the Court stated that the arguments at issue here [illegible] under the category of being an "interpretative rule". (App. A, infra, 15-16).

The Ninth Circuit's decision in this case, for the first time, validated a precedent for any government agency to avoid its regulations to evade the procedures mandated by Congress in the APA.

Section 553(a) of the APA states that the notice requirement shall apply absent certain specified exceptions. By its holding in this case, the Ninth Circuit has improperly exempted the Internal Revenue Service from the notice provision of the APA since such exemption can only be provided by Congressional action.

More specifically, Section 553(a) of the APA states:

> a) This section applies according to the provisions thereof, except to the extent there is involved (1) a military or foreign affairs function of the United States, or (2) a matter relating to agency management or personnel or to public property, loans, grants, benefits or contracts.

Despite the Internal Revenue Service's own regulations, which mandate compliance by

Section 553(a) of the APA states that the notice requirement shall apply except certain specified exceptions. By its holding in this case, the Ninth Circuit has implicitly exempted the Internal Revenue Service from the notice provision of the APA since such exemption can only be provided by Congressional action.

More specifically, Section 553(a) of the APA states:

a) This section applies according to the provisions thereof, except to the extent there is involved (1) a military or foreign affairs function of the United States, or (2) a matter relating to agency management or personnel or to public property, loans, grants, benefits or contracts.

Despite the Internal Revenue Service's own regulations, which mandate compliance by

the Commissioner with the requirements of APA § 553 when formulating and adopting rules and regulations (See 26 C.F.R. 601.601(a)(2)(d) and 26 C.F.R. 601.702(a)(1)), the Court exempted the Internal Revenue Service from such compliance. This decision, when coupled with the holding of the Tax Court in Wing v. Commissioner, 81 T.C. 17 (1983),[4] must be read

---

[4]The Tax Court in Wing v. Commissioner, 81 T.C. 17, 30 n.17, without referring to any authority states:

"Even though in Wendland we stated that we see no inherent conflict between the APA and the Code, were such a conflict to in fact be unavoidable, this would not alter our decision. The APA is a general statute, applying equally to all Federal agencies (unless excepted). The Code, and more specifically sec. 7805, reflects a specific Congressional action to address a particular issue (the power of the Secretary to establish regulations necessary to accomplish the raising and collecting of revenue). If two statutes conflict or overlap in application, the rule is that the more specific of the two takes precedence. As stated by the Supreme Court:

'for it is familiar law that a specific statute controls over a general one "without

the Commissioner with the requirements of APA § 553 when formulating and adopting rules and regulations (see 26 C.F.R. §601.601(a)(2)(ii) and 26 C.F.R. 601.702(a)(1)), the Court advised the Internal Revenue Service to such compliance. This decision, when coupled with the holding of the Tax Court in King v. Commissioner, 51 T.C. 10 (1968),[8] must be read

[8]The Tax Court in King v. Commissioner, 51 T.C. 10, 20 n.17, without referring to any authority stated:

"Even though in Zandlaing we stated that we see no inherent conflict between the APA and the Code, were such a conflict to in fact be unavoidable, this would not alter our decision. The APA is a general statute, applying equally to all Federal agencies (unless excepted). The Code, and more specifically sec. 7805, reflects a specific Congressional action to address a particular issue (the power of the Secretary to establish regulations necessary to accomplish the raising and collecting of revenue). If two statutes conflict or overlap in application the rule is that the more specific of the two takes precedence. As stated by the Supreme Court:

"For it is familiar law that a specific statute controls over a general one "without

as exempting the Internal Revenue Service from compliance with the requirements of the APA in general.

Neither the APA nor the Internal Revenue Service's own regulations provide the Commissioner with an exemption from the requirement of publishing in the Federal Register a substantive rule at least 30 days before its effective date. Nowhere does the APA or the internal rules of the Internal Revenue Service authorize the alternative publication of regulatory changes, such as in a newspaper publication as was done in the instant case.

---

regard to priority of enactment. Bulova Watch Co. v. United States, 365 U.S. 753, 758 (1961)".'"

Petitioner disagrees with the above position inasmuch as the original power to create the regulation springs from Section 611 of the Internal Revenue Code not Section 7805 of the Internal Revenue Code, thereby making the above analysis logically improper.

as exempting the Internal Revenue Service from compliance with the requirements of the APA in general.

Neither the APA nor the Internal Revenue Service's own "regulations grant" the [illegible] alone with an exemption from the requirement of publishing in the Federal Register a [illegible] at least 30 days before its effective date. [illegible] [illegible] of the Internal Revenue Code also authorize the alternative publication of regulatory changes, such as in a newsletter [illegible] publication or the [illegible].

---

regard [illegible] v. United States, [illegible] (1978).

Petitioner disagrees with the above position inasmuch as the original power to create the regulation springs from Section 301 of the Internal Revenue Code not Section 1503 of the Internal Revenue Code, therefore using the above analysis logically improper.

The Eighth Circuit and Tenth Circuit in United States v. Gavrilovic, 551 F.2d 1099, (8th Cir. 1977) and Rowell v. Andrus, 631 F.2d 699 (10th Cir. 1980), respectively, based on the legislative history, construe APA § 553(d) as establishing a separate requirement that a substantive rule be published in the Federal Register in final form not less than 30 days before its effective date.

However, the Ninth Circuit, although silent on the issue of a separate requirement for publication, in Washington State Farm Bureau v. Marshall, 625 F.2d 269, 306 n.19 (9th Cir. 1980), held that the 30-day notice requirement of § 533(d) applies to the publication or service of the notice of proposed rulemaking required by APA § 553(b). This is in direct conflict with the holdings in the

The Eighth Circuit and Tenth Circuit in United States v. Gavrilovic, 551 F.2d 1099, 1104 (8th Cir. 1977) and Rowell v. Andrus, 631 F.2d 699 (10th Cir. 1980), respectively, based on the legislative history, construe APA § 553(d) as establishing a separate requirement that a substantive rule be published in the Federal Register in final form not less than 30 days before its effective date.

However, the Ninth Circuit, although silent on the issue of a separate requirement of publication, in Washington State Farm Bureau v. Marshall, 625 F.2d 296, 306 (9th Cir. 1980), held that the 30-day notice requirement of § 553(d) applies to the publication of notice of the notice of proposed rulemaking required by APA § 553(b). This is in direct conflict with the holdings in the

Eighth and Tenth Circuits and mandates review.

The APA was enacted to provide that administrative procedures affecting individual rights and obligations be promulgated pursuant to certain stated procedures so as to avoid the inherently arbitrary nature of unpublished ad hoc determinations. Morton v. Ruiz, 415 U.S. 199 (1974).

The legislative history of § 553(d) reveals that the purpose of the time lag following publication of a regulation in final form is to "afford persons affected a reasonable time to prepare for the effective date of a rule or rules or to take any other action which the issuance of the rules may prompt." Gavrilovic, 551 F.2d at 1104. It is apparent that APA § 553 was designed with the specific

legislative intent of requiring non-exempt agencies, such as the Internal Revenue Service, to publish in the Federal Register new substantive rules. The notice requirement is based on fundamental principles of fairness and due process.

A taxpayer should be able to rely on currently published regulations to properly plan for the consequences emanating from his business transactions. The conclusion reached by the Ninth Circuit permits the Internal Revenue Service and other agencies to circumvent the APA rulemaking requirements, and abrogate these fundamental principles, which will result in arbitrary, ad hoc determinations.

The Ninth Circuit's misunderstanding of Section 553 of the APA and its misapplication of the APA to this case has created a con-

legislative intent of regulating more-overt behaviors, such as that involved [illegible] gen-cies, to subject to the rule of [illegible] the substantive values. The [illegible] requirement is [illegible] "judgments" [illegible] [illegible]ness and due process.

A [illegible] result [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] for the [illegible] [illegible] from the [illegible] [illegible]. The [illegible] [illegible] of the Ninth Circuit [illegible] the [illegible] between [illegible] and [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] which will result in [illegible] and [illegible] [illegible].

The Ninth Circuit's misunderstanding of section [illegible] of the Act and its misinterpretation of the Act to this case has created a con-

flict among the circuits which mandates a review by this Court.

The Ninth Circuit alternatively stated that the Internal Revenue Service need not comply with APA § 553 because Treas. Reg. § 1.612-3(b)(3) was an "interpretative rule" which came within an exception to the publication requirement. The Ninth Circuit based its holding on the fact that the regulation was amended "in order to revoke an erroneous interpretation of the earlier regulation." The supposedly erroneous interpretation of Treas. Reg. 1.612-3(b)(3) was based upon two revenue rulings (Rev. Ruls. 70-20 and 74-214) that gave this regulation an overbroad construction. (App. A, infra, 16).

The Court's reasoning for holding Treas. Reg. § 1.612-3(b)(3) as an interpretative rule is incorrect. This holding is in con-

flict with the Fifth Circuit's decision in <u>Green v. United States</u>, 460 F.2d 412 (5th Cir. 1972). The Fifth Circuit, in <u>Green</u>, was reviewing Treas. Reg. § 1.611-2, a regulation adopted at the same time as Treas. Reg. 1.612-3(b)(3) pursuant to the Commissioner's authority under Section 611. The Fifth Circuit, in a footnote to its opinion in <u>Green</u> 460 F.2d at 417, n.4, discussing Treas. Reg. 1.611-2 stated that:

> It is well settled that Treasury regulations are binding on the Government as well as on the taxpayer. E. g., Brafman v. United States, 5 Cir. 1967, 384 F.2d 863, 866. Moreover, regulations long continued without substantial change are considered to have received Congressional approval and have the force of law. United States v. Correll, 1967, 389 U.S. 299, 88 S.Ct. 445, 19 L.Ed.2d 537. Although there is no precise cut-off point when a regulation achieves sufficient venerability to warrant recognition, we have no trouble concluding that the regulation before us must govern the valuation of the remainder interests sold by Central Oil Company. The regulation was promulgated in 1960, has survived a

[illegible]

[illegible]

> major tax reform act which focused considerable attention on mineral income taxation, and, in any event, we do not understand the Government to contest the applicability of the regulation.

Implicit in the Fifth Circuit's decision in Green, the court found the regulation to be legislative.

Moreover, in Wing v. Commissioner, 81 T.C. at 28, the court reviewed the applicability of the APA to Treas. Reg. § 1.612-3(b)(3) and stated:

> However, in the instant case, section 1.612-3(b)(3), Income Tax Regs., was promulgated pursuant to specific statutory authority. Section 611(a) provides that taxpayers are allowed a reasonable allowance for depletion to be made under regulations prescribed by the secretary." In addition, section 1.611-0, Income Tax Regs., provides in part:
>
> Where regulations have been enacted pursuant to a specific statutory authority in addition to that provided by section 7805(a), we have afforded them great weight.

[illegible]
regulation.

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

> We therefore agree with petitioner that section 1.612-3(b)(3), Income Tax Regs., is a substantive rule, legislative in character and therefore is subject to the basis and notice requirements of 5 U.S.C. secs. 553(c) and 553(d).

The decision of the Tax Court in Wing that Treas. Reg. 1.612-3(b)(3) is a legislative regulation is substantiated by the Fifth Circuit's decision in Green.

The court's rationale for its decision in this case was based on the need to correct the severely broad construction given Treas. Reg. § 1.612-3(b)(3) by Rev. Ruls. 70-20 and 74-214. However, the alleged erroneous interpretation asserted was not contained in the treasury regulation, but in the two revenue rulings. The Ninth Circuit's opinion is silent as to any impropriety of the regulation itself. Revenue Rulings merely represent the opinion of the Commissioner

and, as such, can be revoked retroactively if contrary to law. Dixon v. United States, 381 U.S. 68 (1965); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957). In any event, it is not disputed that the Commissioner could have merely retroactively withdrawn the two erroneous revenue rulings and issued a new revenue ruling to provide for a proper interpretation of the treasury regulation as seen by the Commissioner. The Ninth Circuit failed to consider this alternative in its opinion. It should be noted that previous Commissioners had seen no reason to change the two revenue rulings' interpretation of the regulation.

Treasury regulations are broadly categorized into two types: legislative regulations where Congress has delegated the specific authority to the Secretary of the Treasury in certain Code sections to enact

[illegible]

[illegible]

detailed rules; and interpretative regulations containing the Internal Revenue Service's interpretation of the various sections of the Code which serve to provide guidance to the taxpayer and service personnel. Rogovin, "Four R's: -- Regulations, Rulings, Reliance and Retroactivity - A View From Within." 42 Taxes 756 (1975), 9 STAND. FED. TAX REP. (CCH)¶ 5980A.015.

Treas. Reg. § 1.612-3(b)(3) was a legislative regulation, promulgated pursuant to the legislative authority granted the Secretary of Treasury under § 611(a), which granted the Commissioner the authority to make reasonable allowances for depletion. The Ninth Circuit, in its decision, misconstrued this regulation and held it to be an interpretative regulation. The Ninth Circuit's analysis attempted to compare the APA with Section 7805(b), but should have

compared the APA with Section 611 of the Internal Revenue Code.

The history of Section 611 of the Code establishes the legislative authority for the issuance of Treas. Reg. § 1.612-3(b)(3). Section 23(m) of The Internal Revenue Code of 1939 (hereinafter "1939 Code") (the predecessor of § 611) contains a specific grant of legislative authority to prescribe regulations for determining the amount of reasonable allowance for depletion deduction. The 1940 predecessor of Treas. Reg. § 1.612-3(b)(3), T.D. 4960, 1940-1 C.B. 38, as amended 26 C.F.R. § 39.23(m)-10 (1939), was clearly issued pursuant to the authority of § 23(m) since the regulation was numbered under that section.

This point is further strengthened by Reg. § 1.611-0 which states "§§ 1.611 through

1.614-8 inclusive, are prescribed under the authority granted the Secretary or his delegate by § 611(a) of the Code..." The regulation on its face boldly states that Reg. § 1.612-3(b)(3) was adopted pursuant to the authority of § 611(a).

Clearly, the amendment to Treas. Reg. § 1.612-3(b)(3) was "legislative" which changed the meaning of the regulation requiring the Commissioner to comply with the APA.

The Ninth Circuit's decision allows the circumvention of the protection provided to the public in the APA by requiring publication of final regulations. If the decision is allowed to stand, the Commissioner will no longer need to publish or provide notice to the public of changes in a substantive rule of long-standing, as the

opinion of the Ninth Circuit allows the mere publication in a newspaper to sufficiently change the substantive tax laws of the country. Congress could never have intended this result when it enacted the APA. The prior regulation has been implicitly categorized as legislative in the case of Green, 460 F.2d at 417, has not been rebutted by the Government in its Brief, nor distinguished by the Ninth Circuit in its opinion. Sound legal reasoning will not justify a finding that the regulation is not legislative.

The Ninth Circuit opinion is difficult to reconcile in light of the above subsequent Tax Court decision holding the regulation to be substantive in character. Therefore, this Court should review the appellate ruling under its powers of supervision.

2. WHETHER § 7805(b) OF THE INTERNAL REVENUE CODE OF 1954, AS AMENDED (26 U.S.C. § 7805(b)), PROVIDES THE COMMISSIONER OF INTERNAL REVENUE WITH THE UNLIMITED AUTHORITY TO RETROACTIVELY APPLY TREASURY REGULATIONS NOTWITHSTANDING NONCOMPLIANCE WITH THE NOTICE REQUIREMENTS OF APA § 553(d) WHICH CAUSES DISPARITY OF TREATMENT BETWEEN SIMILARLY SITUATED TAXPAYERS

A review is required of the decision of the Ninth Circuit affirming the decision of the United States Tax Court granting the Commissioner the unlimited authority to apply treasury regulations retroactively.

Section 7805(b) provides the Commissioner with the authority to prescribe the extent, if any, to which any ruling or regulation relating to the internal revenue laws shall apply without retroactive effect. This power, however, is not unlimited.

The Ninth Circuit in its opinion reaches the conclusion that the Commissioner's power under Section 7805(b) to make

retroactive application of a treasury regulation is unlimited except for review for abuse of discretion. The Ninth Circuit, relying upon its own opinion in _Manocchio v. Commissioner_, 710 F.2d 1400, 1403 (9th Cir. 1983), states that _treasury regulations_ are ordinarily retroactive to the effective date of the statute to which they relate, unless the Secretary limits such retroactive application. However, in _Manocchio_, the Ninth Circuit was not reviewing the retroactive application of a _treasury regulation_, but the retroactive application of a _revenue ruling_.

Revenue rulings are not endowed with as much weight as treasury regulations. A revenue ruling is an interpretation by the Internal Revenue Service, issued by the National Office and published in the Internal Revenue Bulletin for the _information_ and _guidance_ of taxpayers, service personnel and

others concerned. Rogovin, _supra_ at ¶ 5980A.0167 at 67,045. Revenue rulings basically set forth the _Commissioner's position_ with respect to a particular issue and permit uniform handling of the issue, both in planning and on audit.

Legislative regulations, in contrast to interpretative regulations, are generally given the force and effect of law and are binding on both the Commissioner and taxpayers unless the regulation exceeds the scope of the delegated power, are contrary to law, or are unreasonable.

Interpretative regulations contain the Internal Revenue Service's interpretation of various sections of the Code and establish the Internal Revenue Service's position. These regulations are adopted pursuant to the authority granted the Secretary in Section 7805(a) to prescribe all needful

rules and regulations as may be necessary by reason of any alteration of law in relation to the internal revenue. Interpretative regulations, while being afforded great weight by the courts, interpret the Code and set forth the Internal Revenue Service's position.

Thus, revenue rulings merely state the Commissioner's position on a particular issue and provide guidance thereon, but are not meant to be relied upon by taxpayers. This point was confirmed in Dixon v. United States, 381 U.S. 68 (1965), where the issue before the Court was the Commissioner's authority to retroactively withdraw an acquiescence issued in the form of a revenue ruling. The Court concluded that the United States was not barred from collecting a tax otherwise lawfully due as the result of the

Commissioner's erroneous acquiescence in a decision, published as a revenue ruling.

Both legislative and interpretative regulations may be amended with prospective effect. Helvering v. Wilshire Oil Co., 308 U.S. 90 (1939). There is, however, considerable confusion in dealing with the Commissioner's authority to retroactively amend regulations.

The courts have upheld the Commissioner's authority to retroactively amend revenue rulings where based on error or mistake of law, Automobile Club of Michigan v. Commissioner of Internal Revenue, 353 U.S. 180 (1957); Dixon, 381 U.S. at 73, or to retroactively apply treasury regulations where no regulation previously existed. United States v. California Portland Cement, 413 F.2d 161 (9th Cir. 1969). However, the Commissioner's ability to retroactively apply

[illegible]

[illegible]

[illegible]

amended legislative regulations of long standing is unsettled. While Section 7805(b) permits retroactive application of rules and regulations, it is unclear if Section 7805(b) will permit the retroactive revocation of a long standing legislative regulation.

Treas. Reg. § 1.612-3(b)(3) was adopted in final form in 1960 by T.D. 6446, 1960-1 C.B. 208, along with Treas. Regs. §§ 1.611 through 1.616, pursuant to the Commissioner's power to make reasonable allowances for depletion under § 611. Sections 611 and 612 were derived from Sections 23(m) and 114(b)(1), respectively, of the 1939 Code. Section 7805(b) was not mentioned at all by prior Commissioners of the Internal Revenue for their authority when originally or subsequently adopting the regulation set forth above.

The provision allowing for the advanced royalty election contained in Reg. § 1.612-3(b)(3) _was first adopted in explicit regulatory_ provision in 1940, in T.D. 4960, 1940-1 C.B. 38, as amended 26 C.F.R. § 39.23(m)-10, (1939). Treas. Reg. § 1.612.3(b)(3) remained unchanged from 1940 until December 19, 1977, when the Commissioner published its amended regulation in final form in the Federal Register and applied it retroactively to October 29, 1976, the date of the announcement of the proposed amendment which appeared by way of newspaper publication.

Courts have afforded treasury regulations great weight where they are long continued. The Supreme Court in _Helvering v. Winmill_, 305 U.S. 79, 83 (1935) stated that:

> Treasury regulations and interpretations long continued without substantial changes, applying to unamended or substantially reenacted

> statutes are deemed to have received Congressional approval and have the effect of law.

This principle was followed in Helvering v. R. J. Reynolds Tobacco Co., 306 U.S. 110 (1939), wherein the Supreme Court sustained the Commissioner's power to change its regulations so as to operate prospectively, but denied the Commissioner's power to apply a new or amended regulation retroactively where the regulation had received the approval of the legislature.

Dean Erwin Griswold, an authority in the area of legislative reenactment as it relates to the Internal Revenue Service, stated in an article on this subject:

> When the Commissioner is dealing with administrative legislation, he should be free to change it prospectively within the scope of the original grant to him of legislative power; he should not be free to change it retroactively, at

> least against the interest of the taxpayer.

Griswold, _A Summary of the Regulations Problem_, 54 Harv. L. Rev. 398, 412 (1941).

Dean Griswold concluded that in certain situations, such as in the early formulative days of a regulation, retroactive amendments may be appropriate, but that once a "_regulation has become seasoned, the Commissioner should have no power to make retroactive amendments at least against the interest of the taxpayer._" Griswold, _supra_, at 414. (Emphasis supplied).

The Ninth Circuit, in sustaining the Commissioner's action, acknowledged the concept of legislative reenactment but ignored its application herein. The Ninth Circuit, in its opinion, focused not on whether the regulation was long continued and had been legislatively reenacted, but on the alleged

erroneous interpretation given Reg. § 1.612-3(b)(3) by Rev. Ruls. 70-20 and 74-214. Neither the Ninth Circuit, the Tax Court, nor the Internal Revenue Service have offered any support or authority that the regulation was ever unclear, unsettled, or even vague.

The Ninth Circuit thus permitted the Commissioner to retroactively apply the amendment to Reg. § 1.612-3(b)(3) in order to correct two allegedly erroneous revenue rulings which could have properly been retroactively withdrawn. The Ninth Circuit, in sustaining the Commissioner's action, expands the Commissioner's authority to retroactively amend a regulation without limitations. In this case, the Commissioner justified his actions based upon his determination that his previously issued revenue rulings were incorrect; therefore, the

regulation which the revenue rulings interpreted is incorrect.

Moreover, retroactive application of treasury regulations should not be permitted where its application would be against the interest of the taxpayer or would result in disparative treatment between similarly situated taxpayers. Anderson Clayton & Co. v. United States, 562 F.2d 972 (5th Cir. 1977), cert. denied, 436 U.S. 944 (1978). The Ninth Circuit recognizes this principle, but ignores its application. (App. A, infra, 12). (See also Schuster v. Commissioner, 312 F.2d 311, 317 (5th Cir. 1962).) The Fourth Circuit disagrees with the Ninth Circuit where circumstances such as occurred in Elkins v. Commissioner, 81 T.C. 669 (1983), reveal an unfair disparity in the Commissioner's treatment of similarly situated taxpayers (see, e.g., Farmers' & Merchants' Bank v. United States, 476 F.2d 406

[illegible]

[illegible]

(4th Cir. 1973); _International Business Machines Corp. v. United States_, 343 F.2d 914 (Ct. Cl. 1965)); or other unusual circumstances are present.

Petitioner points this Court to the recent decision of the Tax Court in _Elkins_, which involved a taxpayer who after October 29, 1976 (the date of the proposed amendment of Reg. § 1.612-3(b)(3)) invested in and became a partner of a coal partnership formed and obligated to pay advanced royalties prior to this date. The Tax Court in interpreting Reg. § 1.612-3(b)(3) concluded that the partnership was the party to be bound under the regulation and not the partner.

Thus, under the Tax Court's interpretation in _Elkins_, a taxpayer who invested _after_ October 29, 1976 in a partnership formed and obligated to pay an advanced royalty _prior_ to

October 29, 1976 would not come within the amended regulation. However, a taxpayer who invested after October 29, 1976 in a partnership which was formed and obligated to pay an advanced royalty after October 29, 1976 would come within the dictates of Treas. Reg. § 1.612-3(b)(3) as amended.

This disparity of treatment of taxpayers who are similarly situated is the result of allowing the Commissioner to effectuate substantive retroactive changes in the tax treatment of business transactions without consideration of due process of law.

This result stems from the Commissioner's retroactive application of the amended regulation to an arbitrary date. As such, similarly situated taxpayers suffer inequitable and disparate treatment under Reg. § 1.612-3(b)(3), as amended.

Thus, a review of the Ninth Circuit Court of Appeals decision affirming this action is required.

3. THE TAX COURT EXCEEDED ITS JURISDICTION IN EXERCISING ARTICLE III POWERS OVER CONSTITUTIONAL MATTERS APPURTENANT TO THE DETERMINATION OF FEDERAL TAX DEFICIENCY

A review is required of the Appellate Court's decision affirming the Tax Court's jurisdiction over constitutional issues related to the determination of a Federal tax deficiency.

Petitioner does not argue the constitutionality of the creation of the Tax Court as perceived by the Appellate Court,[5] but rather asserts that the Tax Court, as an Article I Court, lacks subject matter jurisdiction to decide matters of constitutional

---

[5] See opinion, Redhouse v. Commissioner, App. A, Vol. II, P. 1, n.2

concern which require due process review. The Tax Court is not an independent, competent judiciary vested with Article III Powers to review compliance of a regulation in accordance with the APA.

The Tax Court, previously called the Board of Tax Appeals, was an independent agency of the Executive Branch until 1969 when it was made an Article I Court by the Tax Reform Act of 1969.[6] Its judges serve for terms of fifteen (15) years and have no rights to undiminished salary as Article III judges do. The court was established solely to determine deficiencies of Federal Income, Estate and Gift Tax liability.[7] Anything not relating to the determination of Federal

---

[6] P.L. 91-172, 83 Stat. 730, § 951, 26 U.S.C. § 7441 et. seq.

[7] 26 USC § 7442.

Congress which requires due process review, the Tax Court is not an "independent," Competent judiciary vested with Article III Powers to review compliance of a regulation in accordance with due process.

The Tax Court, improperly called the Board of Tax Appeals, was an independent agency of the executive branch until 1969 when it was made an Article I Court by the Tax Reform Act of 1969.[9] Its judges serve for terms of fifteen (15) years and have no rights to undiminished salary as Article III judges do. The Court was established solely to determine deficiencies of federal income, estate and gift tax liability,[10] and nothing relating to the determination of federal

[9] P.L. 91-172, 83 Stat. 730, § 951; 26 U.S.C. § 7441 et. seq.

[10] 26 USC § 7442.

taxes is not within the subject matter jurisdiction of the Court. Section 7441. When an Article I court exercises judicial power, when its judges do not have Article III status, then that court lacks subject matter jurisdiction.

Under the theory of separation of powers, if a function is judicial in nature, it is best performed by an independent judiciary. Congress established the Tax Court as a legislative rather than as a constitutional court and purposefully denied the Tax Court judges the constitutional guarantees of tenure and salary, thereby denying the Tax Court any status as an independent judiciary. In Fairmont Aluminum Co. v. Commissioner, 22 T.C. 1377, 1384-85 (1954), the Tax Court stated that:

> Whatever label might be used to characterize this Court for various purposes, its procedures are, and were intended by Congress to be, in every sense of the word, judicial

[illegible]

[illegible]

[illegible]

> [illegible]

... We hear and decide only real controversies between adverse parties, following procedures that are inherently judicial. We make no independent investigation of the facts as do some agencies labeled "administrative" either upon our own motion or upon the motion of one of the parties; our findings of fact are based solely on evidence submitted to us by the parties in accordance with prescribed rules. We do not appear as parties in Court to enforce our orders or the law as do so-called administrative agencies. Our findings of fact carry the same weight as those made by a District Court sitting without a jury.

The House Committee on the Judiciary has stated similarly that: "The Tax Court of the United States is already a court in both name and fact, exercising purely judicial functions..."

It has no jurisdiction to exercise the broad common law concept of "judicial power" invested in courts of general jurisdiction by Article III of the Constitution. Burns, Stix

Friedman & Co., Inc. v. Commissioner of Internal Revenue, 57 T.C. 392, 396 (1971). cf. Anthony v. Commissioner, 66 T.C. 367 (1976).

The Tax Court cannot be deemed to be independent of the Treasury Department considering the one-sided success rate of the Government prevailing in this tribunal.[8]

In an analogous case concerning the constitutionality of the Bankruptcy Courts, the Supreme Court stated in Northern Pipeline Construction Company v. Marathon Pipeline Company, 458 U.S. 50, 62 (1982),"...our

---

[8] The 1982 Annual Report published by the Commissioner and the Chief Counsel of the Internal Revenue Service revealed that the Government prevailed in 82.7% of all cases tried in the Tax Court. Additionally, the Commissioner of Internal Revenue's report to the Secretary of the Treasury revealed that taxpayers in 1983 won a complete victory in only 4.7% of the regular tax cases in Tax Court compared to 37% in District Court and 50% in Claims Court.

[illegible]

[illegible]

[illegible]

[illegible]

Constitution unambiguously enunciates a fundamental principle -- that the 'judicial power of the United States' must be reposed in an independent judiciary. It commands that the independency of the judiciary be jealously guarded, and it provides clear institutional protections for that independency."

In that case, the Court held that 28 U.S.C. § 1471 unconstitutionally delegated Article III powers to a non-Article III Court (the Bankruptcy Court).

The Ninth Circuit failed to adequately address this issue -- which was raised in brief and in oral argument -- on the basis that it was not properly raised. This is contrary to the Supreme Court's holding stated in Glidden v. Zdanok, 370 U.S. 530 (1965) that subject matter jurisdiction of a

Court can be raised at any time, even on appeal.

The Tax Court must decline to take jurisdiction of a case where it lacks jurisdiction on its own motion even though the jurisdictional ground is not raised by the parties. Ruby, 2 B.T.A. 377 (1925); Wheeler's Peachtree Pharmacy Inc. v. Commissioner of Internal Revenue, 35 T.C. 177 (1960). Thus, as in all other instances, a jurisdictional plea may be raised at any time, even on appeal. This is particularly true because of the Court's limited jurisdiction as an Article I, legislative court. In the present case, the court failed to decline jurisdiction of the issue regarding Internal Revenue Service compliance with the APA.

In the instant case, the Petitioner's Constitutional guarantees of procedural due process were abrogated. The Tax Court incor-

rectly exercised its limited powers of jurisdiction and ruled on issues related to compliance with the APA, rather than on issues involving the determination of tax deficiency. The failure of the Tax Court to properly recognize that such action involved constitutional issues which must be considered in an Article III Court setting is a violation of the due process and equal protection clause of the United States Constitution. The Tax Court is not vested with the necessary jurisdiction wherein these issues can be appropriately determined. Section 7441; Northern Pipeline Construction Company, 458 U.S. 50.

The distinction between powers of Article I Courts versus Article III Courts is set forth in McQuiston v. Commissioner of Internal Revenue, 78 T.C. 807 (1982), aff'd, 707 F.2d 1082 (9th Cir. 1983). That case was

decided in the Tax Court by Judge Sterrett, who rendered the Tax Court decision in the instant case.

In McQuiston, Judge Sterrett stated that the Tax Court was an Article I Court and held that it did not have authority to award attorneys' fees for Tax Court litigation under the Equal Access to Justice Act, Pub. L. 96-481, tit. II, Sec. 204(a), 94 Stat. 2327 (effective Oct. 1, 1981). The court reasoned that the Equal Access to Justice Act could only be applied under the jurisdiction of a court established under Article III of the United States Constitution.

The Tax Court's ruling in McQuiston recognized its limitations as an Article I Court, whereas it failed to recognize the same limitations while applying the APA

statutes to the issues presented in the instant case.[9]

This conflicting treatment by the Tax Court of its Article I jurisdiction, and the Appellate Court's subsequent affirmation thereof, sets forth grounds for an exercise of this court's powers of supervision and review on Writ of Certiorari.

This Court should grant certiorari to consider if the Tax Court has jurisdiction to decide matters of constitutional concern which are unrelated to issues involving the collection and determination of a Federal tax liability.

---

[9]Congress has since authorized for proceedings commencing after February 28, 1983, the award of reasonable litigation costs where a taxpayer prevails in United States Tax Court and the government's position was unreasonable. See Tax Equity and Fiscal Responsibility Act of 1982, P.L. No. 97-248, Title II, § 292(a), (e)(1), 96 Stat. 324, 572, 574.

CONCLUSION

The case below has rendered a decision which conflicts with the opinions rendered in other circuits (Eighth Circuit and Tenth Circuit) as to the application of the notice requirements of the APA to the Internal Revenue Service. Additionally, this case raises serious issues of Federal law which have not been resolved and thus should be settled by this Court. Therefore, for the reasons and authorities cited herein, the Petitioner strenuously urges this Court to grant its Petition for Writ of Certiorari in this case.

BERNSTEIN, BERNSTEIN & STEIN
Attorneys for Petitioner
1164 East Oakland Park Boulevard
Fort Lauderdale, FL 33334
(305) 563-3205

ZAYLE A. BERNSTEIN

Jack Stein

JACK STEIN

84-104 (2)

No.

IN THE

Supreme Court of the United States

OCTOBER TERM 1984

RUSSELL REDHOUSE, JR.,

PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

APPENDIX

ZAYLE A. BERNSTEIN
JACK STEIN
COUNSEL FOR PETITIONER
BERNSTEIN, BERNSTEIN & STEIN
1164 East Oakland Park Boulevard
Fort Lauderdale, Florida 33334
(305) 563-3205

69 pp

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

RUSSELL REDHOUSE, JR., Appellant,	)	No. 83-7440
vs.	)	
COMMISSIONER OF INTERNAL REVENUE, Appellee,	)	O P I N I O N

Appeal from the decision of the
United States Tax Court
Argued and submitted February 16, 1984

Before: ANDERSON, SCHROEDER, and ALARCON, Circuit Judges.

ALARCON, Circuit Judge:

Russell Redhouse Jr. (Redhouse or taxpayer), a limited partner in Tennessee Coal Resources, Ltd. (TCR), filed a petition in the United States Tax Court seeking redetermination of deficiencies in his federal income tax for the 1976 taxable year. The Tax Court consolidated Redhouse's case

with those of other TCR partners and sustained the Commissioner's determination of deficiencies. Wendland v. Commissioner, 79 T.C. 355 (1983). Redhouse, a California resident, here appeals the decision entered against him pursuant to I.R.C. § 7482. The other partners, all Florida residents, have filed an appeal in the Eleventh Circuit.

In this appeal, Redhouse challenges the retroactive application of Treas. Reg. § 1.612-3(b) (3), T.D. 7523, 1978-1 C.B. 192, to a coal mining lease acquired on December 31, 1976. We find such application permissible and therefore affirm the decision of the Tax Court.

FACTS

Redhouse is a limited partner in TCR, a partnership formed on December 30, 1976. On December 31, 1976, TCR acquired a coal mine by transferring $650,000 cash and a

nonrecourse note for $2,350,000 to L. D. Rowlette, the lessor of the mine. TCR characterized the entire amount as an advance royalty and claimed a deduction of $3,000,000 on its 1976 return. The Commissioner disallowed the deduction, because no coal was mined in 1976. The Commissioner relied on an amendment to Treas. Reg. § 1.612-3(b) (3) that provided in pertinent part that advanced royalties are deducted from gross income in the year the mineral is produced. T.D. 7523, 1978-1 C.B. 192.

The taxpayer had notice of the proposed amendment before obligating himself to the transaction. On October 29. 1976, the Internal Revenue Service (IRS) issued a news release announcing the forthcoming publication in the Federal Register of proposed amendments affecting mineral leases entered into on or after October 29, 1976.

The IRS also announced the suspension of Rev. Rul. 70-20, 1970-1 C.B. 144 (advance minimum royalties, required for first nine years of lease, may be deducted in the year paid or accrued), and Rev. Rul. 74-214. 1974-1 C.B. 148 (lump-sum payment, recoupable at specified rate in later years, is deductible when paid or accrued). News Release IR-1687, Oct. 29, 1976. A copy of the proposed amendments was attached to the news release. The proposed amendments were published in the Federal Register on November 2, 1976, with an announcement that public hearings would be held on November 30, 1976, and that written comments must be submitted by November 23, 1976. These announcements were also published in the November 15, 1976, issue of the Internal Revenue Bulletin. The final version of the amendments (with no significant changes from the proposed amendments) was published in the Federal

Register on December 19. 1977. Also on December 19, 1977, Rev. Rul. 77-489, 1977-2 C.B. 177, announced the revocation of Rev. Rul. 70-20 and Rev. Rul. 74-214.

DISCUSSION

I.

I.R.C. § 7805(b) gives the Secretary of the Treasury the discretion to limit the retroactive effect of treasury rules or regulations. Thus, treasury regulations are ordinarily retroactive to the effective date of the statute to which they relate, unless the Secretary limits such retroactive application. See Manocchio v. Commissioner, 710 F.2d 1400, 1403 (9th Cir. 1983) (§ 7805(b) establishes presumption that rulings are retroactive). The decision of the Commissioner, the delegate of the Secretary, to make a ruling or regulation retroactive is reviewed for an abuse of

discretion. _Automobile Club of Michigan v. Commissioner_ 353 U.S. 180, 184 (1957) (upheld retroactive revocation of ruling exempting club from income taxes); _Manocchio_, 710 F.2d at 1402 (upheld retroactive application of a revenue ruling disallowing deduction of reimbursed flight training expenses).

A.

Courts have declined to give retroactive effect to regulations that change settled law. _E.g., Helvering v. R. J. Reynolds Tobacco Co._, 306 U. S. 110 (1939) (Treasury cannot retroactively amend long-standing regulation, which acquired force of law when underlying statute was repeatedly reenacted by Congress without change).

Contrary to Redhouse's contention that the regulations have permitted advanced royalty deductions such as his since 1940

based on statutes going back before the 1939 codification of the internal revenue laws, none of these statutes or regulations favored the taxpayer's position. Prior to the 1977 amendment, regulation section 1.612-3(b) and its ancestors[1]/ provided for the deduction of annual advanced royalty payments and did not refer to a single, lump-sum payment. As Redhouse cited to us, the 1940 amendment to Article 23(m)-10 of Regulations 101 (26 C.F.R. § 9.23(m)-10 (Supp. 1939)) stated in pertinent part:

> (e) If a lessee or other owner of operating rights in one or more mineral properties is required to pay royalties on a specified number of units of mineral annually, whether or not extracted within the year, and may apply any amounts paid on account of units not

extracted within the year against the royalty on mineral thereafter extracted, he may at his option treat the advanced royalties so paid or accrued in either one of the following manners:

(1) As deductions from gross income for the year the advanced royalties are paid or accrue; or

(2) As deductions from gross income for the year the mineral product in respect of which the advanced royalties were paid is sold.

Substantially the same language continued in effect through the 1960 amendment:

(b) Advanced royalties. - (1) If the owner of an operating interest in a mineral

deposit or standing timber is required to pay royalties on a specified number of units of such mineral or timber annually whether or not extracted or cut within the year, and may apply any amounts paid on account of units not extracted or cut within the year against the royalty on the mineral or timber thereafter extracted or cut, . . .

(3) The payor, at his option, may treat the advanced royalties so paid or accrued in connection with mineral property as follows:

> (i) As deductions from gross income for the year the advanced royalties are paid or accrued, or
>
> (ii) As deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid, is sold.

Treas. Reg. § 1.612-3, T.D. 6446, 1960-1 C.B. 208, 226-27.

It was not until 1974 that a revenue ruling interpreted the regulation to allow deduction of a single payment made in advance of mining. Rev. Rul. 74-214, 1974-1 C.B. 148. Even then, the ruling was not without ambiguity. Pomerance, _Coal-leasing arrangements offer substantial tax-shelter benefits_, 44 J. Tax'n 350, 351 & nn. 5-6 (1976) (unclear to what extent coal reserves must exceed recoupment and by what date recoupment must be complete); _see also_ 44 J. Tax'n 381, 382 (1976) (warning that IRS may suspend the revenue rulings to reconsider its position).

The 1977 amendment still permitted deduction of advanced minimum royalty payments but "require[d] that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or

[illegible]

[illegible]

[illegible]

[illegible]

for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount." Treas. Reg. § 1.612-3(b) (3), T.D. 7523, 1978-1 C.B. 192. Thus, the 1977 amendment to the regulation revoked the construction that the 1974 revenue ruling gave to the 1960 amended regulation and returned to the intent of the 1960 amended regulation (as well as earlier versions) that payments be made on an annual basis. The 1974 revenue ruling was not a rule of long-standing such that the government should be estopped from changing it retroactively. Furthermore, it cannot be said that Congress approved the revenue ruling because there was no change in the pertinent underlying statutory law since 1974, and revenue rulings have no force of law. Dixon v. United States, 381 U.S. 68, 73 (1965). The 1977 amendment did not change settled law.

B.

A regulation may not be applied retroactively, if the result would be unduly harsh to a particular taxpayer. _Schuster v. Commissioner_, 312 F.2d 311, 317 (9th Cir. 1962) (recognizing that in rare situations Commissioner may be estopped by detrimental reliance of taxpayer).

Redhouse acquired his limited partnership interest as a result of a confidential offering memorandum dated November 12, 1976. The memorandum specifically referred to the IRS news release of October 29 and the risk that the advanced royalty payment would not be deductible in the 1976 taxable year. Since the taxpayer had notice of the proposed amendments before he entered the transaction, he did not suffer "a profound and unconscionable injury." 312 F.2d at 317. This taxpayer was not relying to his detriment on settled law or on a specific ruling

in his favor; he was relying on suspended rulings and on the invalidity of a proposed regulation.

C.

Redhouse argued that the retroactive application of the amendment to the regulation denied him due process of law. The abuse of discretion standard (see discussion above) is akin to a due process inquiry. The taxpayer had no legitimate expectation that the deduction would be allowed after the Commissioner withdrew the revenue rulings. There was no abuse of discretion and no deprivation of due process.

II.

The Administrative Procedure Act of 1946 (APA) § 4, 5 U.S.C. § 553(d), requires all government agencies to give notice of "proposed rule making" by publication in the

Federal Register 30 days before the effective date of the rule. This requirement does not apply to "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice" or "for good cause." 5 U.S.C. § 553(b) (A)-(B). The Treasury ordinarily follows a notice and hearing procedure for all rules whether interpretative or not. Treas. Reg. § 601.601(a) (2)-(3).

A.

Redhouse contends that the amended regulation is invalid, because it was not published in the Federal Register in its final form 30 days before its effective date.

Redhouse refers us to _Wing v. Commissioner_, 81 T.C. 17 (1983) as authority for the proposition that this regulation was legislative in character and subject to the notice requirement of 5 U.S.C. § 553(d). 81

T.C. at 28. _Wing_ also held that any non-compliance with the notice requirement was technical and the amendment was valid. 81 T.C. at 30. Furthermore, _Wing_ stated that its decision was controlled by _Wendland_, the very case now before us on review. 81 T.C. at 29.

It is doubtful that treasury regulations need to comply with the 30-day notice requirement. The specific statute giving the Secretary of the Treasury discretion to apply statutes retroactively (I.R.C. § 7805(b)) would in any conflict take precedence over the general notice statute (5 U.S.C. § 553(d)). _Wing_, 81 T.C. at 30 n.17 (quoting _Bulova Watch Co. v. United States_, 365 U.S. 753, 758 (1961) (specific controls general without regard to priority of enactment)).

Even assuming that the 30-day notice requirement applies to treasury regulations,

[illegible]

[illegible]

[illegible]

the amendment at issue here falls under the "interpretative rule" exception to the requirement. Although the original depletion regulations, being promulgated pursuant to the express statutory authority of I.R.C. § 611(a), are arguably legislative in character, this amendment to those regulations was issued in order to revoke an erroneous interpretation of the earlier regulation. The erroneous interpretation was based upon two revenue rulings that gave a broad construction to an ambiguity in the regulation. Revenue rulings merely represent the opinion of the Commissioner and are therefore classic examples of interpretative rules. Wing, 81 T.C. at 27. The amendment, changing the Commissioner's revenue rulings, was also of an interpretative nature.

B.

Redhouse also contends that the Tax Court lacks subject matter jurisdiction to decide whether the regulation complied with the APA and that its ruling on this matter constituted a deprivation of due process.

The United States Tax Court is a legislative court under Article I of the United States Constitution. I.R.C. § 7441. It has jurisdiction to determine the correct amount of a deficiency. I.R.C. § 6214.2/ The Tax Court here was not considering the APA issue in the abstract but in connection with the assessment of a deficiency. In orderto determine the correct amount of a deficiency, the court must be able to determine whether or not the tax statutes, regulations and rules are valid. Furthermore, if the Tax Court lacked jurisdiction to pass on the validity of the tax rules, deficiencies might then be

determined according to invalid rules. Having deficiencies determined according to valid rules does not deprive taxpayers of due process. The taxpayer's claim is without merit.

III.

Based on the foregoing analysis, we conclude that the retroactive application of Treas Reg. § 1.612-3(b) (3), T.D. 7523, 1978-1 C.B. 192, was not an abuse of the Secretary of the Treasury's discretion under I.R.C. § 7805(b). The 30-day notice requirement of 5 U.S.C. § 553(d) was not applicable to this interpretative regulation. The decision of the Tax Court is AFFIRMED.

FOOTNOTES

1. Section 611 of the current Internal Revenue Code was derived from Section 23(m) of the Internal Revenue Code of 1939, which was a codification of the then-existing internal revenue laws. In 1939, the regulations that prescribed rules relative to the allowance of depletion deductions were made applicable to the Internal Revenue Code by Treasury Decision 4885 (1939-1 C.B. 396) and added to the Code of Federal Regulations as section 9.23(m)-10 in the 1939 supplement.

2. At oral argument, the taxpayer for the first time attacked the constitutionality of the Tax Court. This argument was untimely. We note, however, that the creation of the Tax Court was constitutional. _Ex Parte Bakelite Corp._, 279 U.S. 438, 451-52 (1929) (Congress may create legislative courts); _Nash Miami Motors, Inc. v. Commissioner_, 358 F.2d 636 (5th Cir.), _cert._

denied, 385 U.S. 918 (1966) (Tax Court is constitutional).

In his reply brief, citing *Nothern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982) (broad grant of jurisdiction to bankruptcy courts declared unconstitutional), the taxpayer contends that the Tax Court "overstepped its jurisdictional boundary in ruling on subject matter under 5 U.S.C. 706 [scope of judicial review of agency action]." Unlike bankruptcy courts that were set up as adjuncts to Article III district courts (458 U.S. at 63 n.13), the Tax Court is a legislative court with limited jurisdiction to rule on deficiencies assessed by the government on its taxpayers. The creation of the Tax Court was within the realm of congressional power. 458 U.S. at 67-70 & n.22 (tax cases involve public rights and may be adjudicated in a legislative

court). The Tax Court was not reviewing agency action in a declaratory relief action under 5 U.S.C. § 706; it was ruling on the amount of a deficiency owed under the specific statutory authorization of I.R.C. § 6214.

OFFICE OF THE CLERK
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

NOTICE OF ENTRY JUDGMENT

Judgment was entered in this case as of the file stamp date on the attached decision of the Court.

PETITION FOR REHEARING (FRAP 40)

Filing time: A petition for rehearing may be filed within fourteen(14) days after judgment.

Purpose: A petition should only be made to direct the Court's attention to one or more of the following situations:

1. A material fact or law overlooked in the decision.

2. A change in the law which occurred after the case was submitted and which appears to have been overlooked by the panel.

3. An apparent conflict with another decision of the Court which was not addressed in the opinion.

Petitions which merely reargue the case shall not be filed.

Statement of

A petition shall contain an introduction stating that, in counsel's judgment, one or more of the situations described above (in Purpose Section) exist. The point to be raised must be clearly stated. Lacking such a statement, the petition will not be filed.

Form:

The fifteen (15) page limit allowed by the rule must be observed. Please use 8 1/2 x 11 inch paper. Three (3) copies of the petition and the original are required unless the petition includes a suggestion for rehearing en banc. If it does, thirty-three (33) copies and the original must be filed.

ROBERT P. WENDLAND AND DONNA C. WENDLAND, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 5708-80—5712-80, 5769-80, 5771-80—5773-80, 9376-80. Filed August 23, 1982.

Petitioners were limited partners in TCR, a partnership that was formed in 1976 to engage in coal mining. On Dec. 31, 1976, TCR paid $3 million to GSA to acquire, among other things, a number of valuable assets that were necessary to the mining operation, including coal leases, a mining agreement, and a coal supply agreement. The payment consisted of $650,000 cash and a $2,350,000 nonrecourse note. Petitioners contend that the entire $3 million was payment of advanced royalty and claimed a deduction under sec. 1.612-3(b)(3), Income Tax Regs., as it read prior to its retroactive amendment, for their pro rata shares thereof. They challenge the validity of the retroactive amendment to the regulations. *Held*, in amending sec. 1.612-3(b)(3), Income Tax Regs., respondent complied with the purposes behind the Administrative Procedure Act, 5 U.S.C. sec. 553(d) (1982 ed.), and retroactivity of the amended regulation was valid exercise of the authority granted under sec. 7805(b), I.R.C. 1954. *Held, further*, the "legislative reenactment doctrine" does not

apply to bar respondent from so amending the regulation. *Held, further*: Some portion of the cash transferred to GSA constituted payment of advanced royalty. The cash portion paid as advanced royalty exceeded the amount of the deduction to which petitioners are entitled for coal actually mined during 1977; therefore, petitioners may deduct the advanced royalty on the coal mined in 1977.

TCR paid $100,000 to the law firm that performed legal work necessary for the organization and marketing of the partnership. *Held, further*, such expenses constituted organizational expenses which must be capitalized under sec. 709, I.R.C. 1954. *Held, further*, miscellaneous deductions claimed by TCR and petitioners are disallowed. *Welch v. Helvering*, 290 U.S. 111 (1933).

Zayle A. Bernstein, *Michael S. Feinman*, *Jack Stein*, *Sidney T. Bernstein*, and *Allan F. Meyer*, for the petitioners.

Roger D. Osburn and *Judy K. Hunt*, for the respondent.

STERRETT, *Judge*: By statutory notices dated March 24, 1980,[2] respondent determined deficiencies in petitioners' income taxes for the taxable years ended December 31, 1973, December 31, 1976, and December 31, 1977, as follows:

Docket No.	*Petitioner*	*Year*	*Deficiency*
5708–80	Robert P. Wendland	1973	$9,990.00
	and Donna C. Wendland	1976	14,270.00
		1977	383.00
5709–80	Irwin M. Adler	1976	56,460.77
	and Helene E. Adler	1977	2,753.93
5710–80	Brent W. Trump	1976	21,777.00
	and Cheryl A. Trump	1977	27,350.00
5711–80	Ronald Glassman	1976	37,585.00
	and Lenora Rae Glassman	1977	835.00
5712–80	Stephen L. Nemerofsky	1976	34,334.13
	and Nina B. Nemerofsky	1977	852.29

5769–80	Gerald L. Gunderson and Judith C. Gunderson	1976 1977	$28,556.00 1,874.00
5771–80	Sherwin Ross and Marlynn Ross	1976 1977	73,524.70 1,548.25
5772–80	Roman M. Wenzel and Emily A. Wenzel	1976 1977	16,218.00 598.00
5773–80	Wilbur F. Helmus, Jr., and Patricia Helmus	1976 1977	20,124.00 23,813.00
9376–80	Russell L. Redhouse, Jr.	1976	12,351.32

The petition of Antonio Gonzalez-Revilla, Jr., and Nair Gonzales-Revilla, docket No. 5770–80, originally was consolidated with the other petitions but was severed from the group by the granting of the oral motion to continue of June 1, 1981.

The issues for our decision are (1) whether, under section 1.612–3(b)(3), Income Tax Regs., as amended by T.D. 7523, 1978–1 C.B. 192, an advanced royalty paid on December 31, 1976, by Tennessee Coal Resources, Ltd. (hereinafter TCR), a limited partnership, is deductible in the year of payment or only in the year when the coal is sold; (2) whether the advanced royalty deduction allowable to TCR includes the amount reflected in the nonrecourse note given by TCR as well as the cash actually paid; (3) whether each petitioner may include his share of the nonrecourse note of the partnership in his basis in TCR; (4) whether TCR properly characterized a payment of $100,000 as deductible legal expenses; and (5) whether petitioners adequately substantiated miscellaneous other deductions claimed on the 1976 and 1977 tax returns of TCR and on the returns of certain individual petitioners.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and supplemental stipulation of facts, together with the exhibits attached thereto, are incorporated herein by this reference.

At the time of filing their petitions herein, petitioners' legal residences were as follows:

Petitioner	*Residence*
Robert P. Wendland and Donna C. Wendland	Lighthouse Point, Fla.
Irwin M. Adler and Helene E. Adler	Miami, Fla.
Brent W. Trump and Cheryl A. Trump	Pompano Beach, Fla.
Ronald Glassman and Lenora Rae Glassman	Plantation, Fla.
Stephen L. Nemerofsky and Nina B. Nemerofsky	Plantation, Fla.
Gerald L. Gunderson and Judith C. Gunderson	Deerfield Beach, Fla.
Sherwin Ross and Marlynn Ross	Miami, Fla.
Roman M. Wenzel and Emily A. Wenzel	Key Biscayne, Fla.
Wilbur F. Helmus, Jr., and Patricia Helmus	Lighthouse Point, Fla.
Russell L. Redhouse, Jr	Santa Clara, Calif.

The income tax returns for the taxable years involved were filed by each of the petitioners with the Office of the Internal Revenue Service at Chamblee, Ga. In addition, on April 5, 1977, Robert P. and Donna C. Wendland filed an application for tentative refund with the Internal Revenue Service Center at Chamblee, Ga., in which they claimed a carryback from 1976 to 1973 of unused net operating loss in the amount of $33,036. Respondent's notice of deficiency in docket No. 5708-80 reflects a disallowance of this deduction.

By confidential offering memorandum dated November 12, 1976, limited partnership interests in Tennessee Coal Resources, Ltd., were offered to various investors. The offering memorandum provided that 900 units were to be sold to limited partners at a price of $1,000 per unit for a total of $900,000. Attached to the offering memorandum were the following exhibits: limited partnership agreement; coal mine description with maps; opinion of tax counsel; unexecuted nonrecourse note; coal supply agreement between Shattuck

Coal Co., et al., and Carolina Power & Light Co.; resume of Edwin Tunick, general partner; lease agreement of November 12, 1976, between Edwin Tunick and L. D. Rowlette; subscription agreement; investor questionnaire; offeree representative questionnaire; and miscellaneous newspaper clippings. To become a limited partner in TCR, each prospective investor was required to have a net worth of at least $100,000 and some portion of his annual gross income taxable at a rate of 50 percent or more.[3]

Tennessee Coal Resources, Ltd., was formed on December 30, 1976. TCR reported its income on the accrual method of accounting. Immediately following its formation, TCR received from its general partner, Edwin Tunick, an assignment of a Claiborne County, Tenn., sublease. In addition, TCR was assigned other assets by an entity entitled GSA Corp., including a coal mining agreement with John T. Walden which included a note receivable and security interest for the sale of equipment, and a coal supply agreement between a number of individuals including Shattuck Coal Co. and Carolina Power & Light Co. The closing of the acquisition of the coal mine (the sublease, coal supply agreement, and coal mining agreement) by TCR was held on December 31, 1976.

Pursuant to the confidential offering memorandum and the attached exhibits, petitioners each acquired limited partnership interests and became limited partners in TCR as follows:

Petitioner	*Payment*	*Date of payment*	*Percentage interest in TCR*
Wendland	[4] $24,500	12/23/76	3.0%
Adler	36,000	12/23/76	4.0
Trump	36,000	12/29/76	4.0
Glassman	30,000	12/29/76	3.2

Nemerofsky	$18,000	12/06/76	2.0%
Gunderson	18,000	12/23/76	2.0
Ross	36,000	12/23/76	4.0
Wenzel	36,000	12/23/76	4.0
Helmus	36,000	12/29/76	4.0
Redhouse	24,000	12/29/76	3.0

Each executed the subscription agreement, the limited partnership agreement, and the investor questionnaire prior to becoming a limited partner in TCR. A total of $900,000 was deposited in the trust account of the law firm of DiGuilian, Spellacy, Bernstein, Lyons & Sanders. The offering memorandum stated that the proceeds were expected to be used as follows:

Use of proceeds	
Cash downpayment for mine of GSA	$650,000
Fixed fee for syndication of the partnership to general partner	100,000
Fee to attorneys for organization, structure, and tax opinion to the partnership	100,000
Working capital	50,000
Total	900,000

1. Coal Leases

The sublease received by TCR contained rights to mine a number of tracts of land and property. The rights that TCR obtained under the sublease and the coal supply agreement were obtained by the lessor and transferor, L. D. Rowlette, in a series of transactions in late 1976. In negotiating for and acquiring such assets, Mr. Rowlette was acting as nominee of GSA Corp., a corporation formed and solely owned by Theodore Neckles. In one such transaction, Mr. Rowlette, as nominee of GSA Corp., agreed to purchase all of the stock and all of the assets of Shattuck Coal Co. and Big Nickel Tipple Co. (collectively referred to as Shattuck stock) from Tom N. Shattuck and Jerry Shattuck. At the time, the assets of Shattuck Coal Co. and Big Nickel Tipple Co. included the following: (1) Certain coal mining equipment; (2) certain leases and agreements for underground mining and tipple operation rights; (3) a coal supply agreement with Carolina Power & Light Co.; and (4) an operating and sales agreement with John

T. Walden. The purchase price of the Shattuck stock as set forth in the October 21, 1976, purchase agreement between the Shattucks and L. D. Rowlette, was $500,000, of which $50,000 was paid as a downpayment and $450,000 was due on or before November 23, 1976, the date for the scheduled closing of the transaction. The closing on the sale of the stock of Shattuck Coal Co. and Big Nickel Tipple Co. to L. D. Rowlette took place on December 8, 1976. Although originally scheduled for November 23, 1976, this date was extended to December 9, 1976, by an extension agreement dated November 24, 1976. Closing actually took place 1 day earlier. The extension agreement also provided that the price at closing would be raised to $550,000.

On November 12, 1976, Mr. Rowlette, as lessor, and Mr. Tunick, as lessee, entered into an agreement (hereinafter the November 12 lease agreement) permitting Mr. Tunick to mine coal on property that was to be described in "Attached Exhibit A." The "Exhibit A" referred to in the lease agreement was not attached to the lease agreement on the date that the agreement was signed. Sometime after November 12, 1976, but on or before December 31, 1976, "Exhibit A" was attached to the lease agreement. Such "Exhibit A" included two leases. One of the leases, for three tracts of land, was dated November 22, 1976, between Clearfork Mining Co., as lessor, and L. D. Rowlette, as lessee. Of those tracts, one (which included a tipple[5] for loading coal) had been leased to Shattuck Coal Co. and was one of the assets of Shattuck Coal Co. that was listed in the October 21, 1976, purchase agreement. This lease required Mr. Rowlette, as lessee, to pay a royalty to the lessor in the amount of $1 per ton of coal that was mined and removed from the leased premises, or 6 percent of the gross selling price of such coal, whichever was greater. It further required the lessee to pay a minimum royalty as rent upon the lands leased of $1,500 per month. Such minimum royalty could be recouped out of earned royalties on any coal mined within 2 years from the date of payment of such minimum royalty.

The other lease included in "Exhibit A" to the November 12 lease agreement was dated December 1, 1976, between Jencie

Thomas and Kizzie LaBoe, lessors, and Shattuck Coal Co., lessee. This lease represented a renegotiation of an earlier lease between the same parties. The earlier lease was one of the assets listed in the October 21, 1976, purchase agreement between the Shattucks and Mr. Rowlette. As renegotiated, the December 1, 1976, lease provided that Shattuck Coal Co. (which was owned by Mr. Rowlette pursuant to the Oct. 21, 1976, purchase agreement), as lessee, must pay each lessor $200 per month for use of the specified property plus a royalty of 5 percent of the gross truck sale price on all coal mined and sold from the leased premises.

The November 12 lease agreement between Mr. Rowlette and Mr. Tunick provided that a $2-per-ton royalty should be paid by the lessee (Mr. Tunick) to the lessor (Rowlette/GSA) for each ton of coal mined and removed from the premises. In addition, the lease agreement provided that the lessee (Tunick) must pay a prepaid royalty of $3 million, payable with $650,000 cash on or before December 31, 1976, and with the issuance of a designated nonrecourse secured promissory note on or before December 31, 1976, in the amount of $2,350,000. The lease agreement further provided that the $3 million was to be recouped out of the first 1,500,000 tons of coal mined and sold.

2. Coal Mining Agreement

Aside from the coal leases, among the assets assigned to TCR on December 31, 1976, by GSA Corp. was a mining agreement between Shattuck Coal Co. and John T. Walden that included a note receivable and a security interest for the sale of equipment. Under such agreement, Mr. Walden was to mine the coal for Shattuck Coal Co. at prices ranging from $15.50 to $18.50 per ton, depending on the quality of the coal and the terms of the coal supply contract with Carolina Power & Light. This mining agreement had been listed as an asset of Shattuck Coal Co. in the October 21, 1976, purchase agreement between the Shattucks and L. D. Rowlette (as nominee for GSA Corp.) and had been transferred to Mr. Rowlette pursuant thereto.

Coal mining equipment that was listed among the assets of Shattuck Coal Co. on the October 21, 1976, purchase agreement actually had been sold by Shattuck Coal Co. to Mr. Walden on the installment basis. Under the mining agree-

ment, Mr. Walden was obligated to pay a total of $75,402.64 for the equipment. The terms of payment were as follows:

> The term of this sale will be five years, total sale price of equipment in schedule A of $75,402.64 at a payment schedule of $1000 per month or $.50 per ton, which ever [sic] is greater. This payment schedule will not be so inflexable [sic] so as to not account for loss of running time caused by labor disputes, uncontrollable equipment breakdown, or working conditions. These payments will begin in the month of October 1976, and continue until the principal of $75,402.64 is consumed. The equipment mentioned is known to require additional repair which costs incurred by Walden will be deducted from the principal, not to exceed $20,000.00. If Walden is unable to profitably work this equipment after diligent and workmanlike procedures have been made, the equipment ownership will return to Shattuck and previous payments paid by Walden for the equipment will be considered liquidated damages. Further, Shattuck herein assigns three leases, held by same, for the assigned royalty payment of each lease, plus $.50 per ton, deducted from the base price paid to Walden. * * *

3. Coal Supply Agreement

A third major asset that was assigned to TCR on December 31, 1976, by GSA Corp. was a supply agreement between Carolina Power & Light Co., purchaser, and a number of sellers including Shattack Coal Co. Such coal supply agreement with Carolina Power & Light Co. was listed as an asset of Shattuck in the October 21, 1976, purchase agreement. Under the supply agreement, Carolina Power & Light Co. agreed to pay a base price of $17.75 per ton f.o.b. railcar at the shipping point for 12,000 BTU/lbs. coal. Shattuck Coal Co. agreed to provide 50,000 tons of coal yearly at such price. Price adjustments were provided in the supply agreement based upon the quality of the coal and the costs associated with mining such coal.

All of the assets acquired by TCR pursuant to the December 31, 1976, transfer of assets were bargained for by L. D. Rowlette as nominee of GSA Corp. during negotiations for purchase of the Shattuck stock. The leases, received from Mr. Tunick, were valuable in that they provided a source of coal. The coal supply agreement with Carolina Power & Light was valuable in that it provided a market for the coal. The operating agreement with John T. Walden was valuable in that it provided a source for mining the coal. Further, some value of the operating agreement was assured in that it provided the holder would receive $75,402.64 as payment for

equipment sold pursuant thereto. The rights in the tipple were valuable because a tipple is essential to the operation of a coal mine. If the coal mine owner does not control a tipple (as most small operators do not), the miner must transport the coal to a tipple owned by someone else and pay for the use of such facility.

In part, disbursements were made from the trust account of DiGuilian, Spellacy, Bernstein, Lyons & Sanders for TCR as follows:

Payee	*Date*	*Amount*
Wire transfer to United American Bank, Knoxville, Tenn	Dec. 31, 1976	$550,000.00
Michael J. Padula[6] trust account	Dec. 31, 1976	100,000.00
DiGuilian, Spellacy, Bernstein	Jan. 14, 1977	52,000.00
Edwin Tunick, general partner, TCR	Jan. 14, 1977	50,000.00
DiGuilian, Spellacy, Bernstein	Jan. 14, 1977	4,671.46
Edwin Tunick, general partner	Feb. 10, 1977	28,382.50
DiGuilian, Spellacy, Bernstein	Feb. 10, 1977	28,382.50
Edwin Tunick	Mar. 11, 1977	10,167.50
DiGuilian, Spellacy, Bernstein	Mar. 11, 1977	10,167.50

With respect to the $550,000 wire transfer to United American Bank, Knoxville, Tenn., such amount was used to pay the amount due from Mr. Rowlette to Tom N. Shattuck and Jerry Shattuck for their stock in Shattuck Coal Co. and Big Nickel Tipple Co. At the December 8, 1976, closing on the sale of the Shattuck stock to L. D. Rowlette (as nominee of GSA Corp.), Mr. Rowlette had given Tom N. Shattuck and Jerry Shattuck a check. This check was not honored because of insufficient funds. The Shattucks eventually received payment by cash-

ier's check from United American Bank in Knoxville, Tenn. With respect to the $100,000 disbursed to Michael J. Padula trust account, such amount was paid over to GSA.

On November 16, 1976, L. D. Rowlette entered into an agreement with GSA Corp. (GSA) wherein it was acknowledged that Mr. Rowlette had been acting as nominee-purchaser for GSA in entering into the purchase agreement with Tom N. Shattuck and Jerry Shattuck to acquire Shattuck Coal Co. and Big Nickel Tipple Co. The November 16, 1976, agreement further provided that Mr. Rowlette was to receive $50,000 as compensation for his services as nominee-purchaser of Shattuck Coal Co. for GSA. This amount was to be paid from proceeds received under the November 12, 1976, lease agreement between Mr. Rowlette and Edwin Tunick. In addition, it was provided that GSA would employ Mr. Rowlette as general manager and operating miner for mines to be operated by GSA.

On November 16, 1976, Mr. Rowlette also executed an authorization directed to Edwin Tunick and/or Zayle Bernstein (attorney for petitioners herein and a member of the law firm that helped to organize TCR and maintain a bank account on behalf of TCR) to pay all funds due under the November 12, 1976, lease agreement to the Michael J. Padula trust account as the attorney for GSA.

The amounts disbursed to Edwin Tunick, the general partner, and to the law firm of DiGuilian, Spellacy, Bernstein, Lyons & Sanders were in compensation for their services in organizing the partnership. Such expenditures were authorized in the limited partnership agreement, which provided as follows:

ARTICLE XIII

ORGANIZATION EXPENSE

The Partnership shall be responsible for all expenses incurred in connection with its organization and related matters including but not limited to legal fees, and for offering expenses not to exceed $200,000.00.

Mr. Tunick, the initial general partner of TCR, was responsible for syndication of the partnership. Mr. Tunick was a certified public accountant with a number of clients who were sophisticated investors. He was informed by a number of practitioners, including Mr. Zayle Bernstein, that tax-shel-

tered investment opportunities were available in the coal industry. Mr. Tunick was responsible for obtaining most of the investors for the TCR venture.

The specific coal mine eventually acquired by TCR was located by Mr. Bernstein. This is evidenced in article XV of the limited partnership agreement which provides for compensation to Mr. Bernstein's law firm as follows:

> The Limited Partners by execution of this agreement * * * ratify, affirm and agree that said compensation to [the law firm of DiGuilian, Spellacy, Bernstein, Lyons & Sanders] * * * shall be One Dollar ($1.00) per ton of the coal mined, removed and sold by the Partnership. It is also agreed by all parties hereto that *part of said compensation is in lieu of any finders fee due for locating the mining property by the said law firm.* [Emphasis added.]

Mr. Bernstein located the coal property through Mr. Theodore Neckles, the sole owner of GSA Corp. Mr. Bernstein also introduced Mr. Tunick to L. D. Rowlette, the nominal purchaser of the coal mine for GSA, and accompanied Mr. Tunick on one trip to examine the mine prior to closing. Mr. Bernstein's firm was responsible for formulating the confidential offering memorandum and attachments, obtaining geological information, rendering a tax opinion, and preparing projections of income and expenses including sales price per ton of coal and mining costs. In addition, Mr. Bernstein helped to locate one investor.

Upon the assignment to TCR on December 31, 1976, of the November 12, 1976, lease agreement between Mr. Rowlette, as lessor, and Mr. Tunick, as lessee, TCR became responsible for all of the terms of that lease. Among the terms was a provision that an advance royalty of $3 million would be paid to the lessor, represented in part by a nonrecourse note in the amount of $2,350,000. On that same date, TCR delivered a nonrecourse note in the amount of $2,350,000 to Mr. Rowlette, who then assigned the note to GSA Corp. The note provided for payment of interest at the rate of 4 percent per annum on the balance of principal remaining until December 15, 1987. Under the terms of the note, the provision respecting payment was as follows:

> The undersigned [TCR] covenants and agrees that cash actually received by the undersigned from the * * * [mine lease] to which the undersigned shall be entitled shall be applied in satisfaction of the principal obligation evidenced by this Note, together with the accrued interest thereon, if any, by

multiplying $1.91 for each ton of coal mined, removed and sold from the Prospect by the fractional percentage interest of the undersigned, as indicated below, in the [mine lease] * * *

However, the promissory note went on to require payment on the principal of the note only if cash were available after payment of other expenses associated with the mine and accrued interest:

No default shall be deemed to have occurred if the undersigned shall apply all cash received by the undersigned (after payment by the undersigned of all costs incurred to mine, remove and sell coal from the * * * [mine], together with any severance taxes, land owners' and surface owners' royalties, and other costs and expenses, reasonable, necessary and appropriate in order to mine, remove, and sell coal from the * * * [mine]), from coal mined, removed and sold from the undersigned's mining interest in the * * * [mine] in satisfaction of the accrued interest, if any, and the unpaid principal obligation of this Note remaining, from time to time, unpaid.

The note was collateralized by the assignment of a security interest in the mineral lease to Mr. Rowlette.

On December 31, 1976, Mr. Rowlette executed an assignment to GSA Corp. of any interest that he had in the sublease.

Also on December 31, 1976, TCR entered into an agreement with GSA providing that the royalty on the coal sold to Carolina Power & Light under the coal supply contract was to be reduced to the extent of any difference between the actual sales price and $23.50 per ton. The agreement provided that:

In the event the purchase price at any time during the duration of the contract with Carolina Power and Light Company * * * is lower than $23.50 per ton, then and in that event, the Partnership may reduce all payments due under the above-referenced lease wherein L. D. ROWLETTE, is Lessor (as assigned to GSA CORPORATION) * * * to the extent of the payments required thereunder but in any event limited to the difference between the selling price of coal by TENNESSEE COAL RESOURCES, LTD., to Carolina Power and Light Company and $23.50. * * * (This provision may be illustrated as follows: In the event during the month of January, 1977 (or any month or months of the Coal Supply Contract) TENNESSEE COAL RESOURCES, LTD., sells coal to Carolina Power and Light Company pursuant to the attached contract for a purchase price of $21.50, then and in that event all obligations due under the Lease Agreement with L. D. ROWLETTE, as Lessor (as assigned to GSA CORPORATION), and EDWIN TUNICK, as Lessee, shall be reduced during that month by $2.00 per ton for all coal sold and mined for that period.)

Accordingly, the full amount of the royalty would only have to be paid if the coal delivered to Carolina Power & Light was

sold at a price of at least $23.50 per ton. If the coal was sold for a lesser amount, payment on the royalty (and thus on the note) was to be reduced or forgiven entirely.

The coal supply contract provided that Carolina Power & Light Co. would pay a base price of $17.75 for 12,000 BTU quality coal, which price would be adjusted if the coal was of higher or lower quality. In order for coal to be sold at $23.50 per ton under the coal supply contract, the quality of coal would have had to exceed 13,000 BTU. In reality, the coal sold to Carolina Power & Light Co. prior to and during December 1976 was of the following quality:

Delivery date	*BTU quality*
July 1976	11,212
Aug. 1976	12,978
Aug. 1976	12,768
Sept. 1976	11,999
Oct. 1976	12,593
Nov. 1976	12,631
Dec. 1976	12,087

The legal opinion attached to the confidential offering memorandum included a cash flow analysis which showed an anticipated cash profit to TCR of $3.49 per ton after payments of all costs including payments of the nonrecourse note to GSA. This assumed a $23.50 per ton sales price (for 13,000 BTU coal), payments to GSA of $1.91 per ton, and mining and other costs of $18.10 per ton. Such other mining costs were calculated as follows:

Underlying royalty	$1.40
Contract miner	[7] 12.00
Hauling	1.10
Severance tax	0.20
Tippling	0.40
General partner fee	1.00

Legal representation fee	$1.00
Administrative expense	1.00
Total	18.10

According to the terms of the nonrecourse note, repayment would have required 1,500,000 tons of coal to be mined. This amount of coal, multiplied by $1.91 per ton (the amount of the payment to the lessor per ton of coal that was to be offset against the principal of the note), would have yielded sufficient funds ($2,865,000) to repay the note and applicable interest.

With respect to the amount of recoverable coal on the leased property, the partnership received a document prepared by Richard E. Bergenback, a geologist at the University of Tennessee. In compiling his report, Mr. Bergenback relied entirely on information supplied by Mr. Tom Shattuck, owner and operator of Shattuck Coal Co., with respect to the thickness of the coal seam and the quality of the coal. Mr. Bergenback did no independent investigatory drilling to test the correctness of the information upon which he based his report. Mr. Bergenback calculated the amount of available coal by multiplying the size of the property (based on 741 acres, of which 10 acres had been mined) by the estimated tonnage of coal per acre. Mr. Bergenback's calculations were based on the assumptions that the average thickness of the coal seam was 30 inches and that the average acre contained 1,800 tons of coal per acre foot. Accordingly, he concluded that there were 4,500 tons of coal per acre. Based on such assumptions, Mr. Bergenback estimated that the entire property contained a total of 3,289,500 tons of coal (741 acres × 4,500 tons). He went on to calculate the estimated recoverable coal as follows:

> If a factor of 50% recovery in deep mining is used, then 1,644,750 tons of Rex Coal may be recovered. If an optimistic recovery factor of 70% is used, then 2,302,650 tons of Rex Coal may be recovered.

In actuality, the property subleased by TCR consisted of only about 630 acres, 10 acres of which already were mined. Furthermore, under the mining plan being used in the mine, it was very unlikely that the percentage of coal that was recoverable would exceed 60 percent.

Prior to the sale of the mine by the Shattuck Coal Co. to L. D. Rowlette, no investigatory or core drilling of the property

was performed. Later core drilling on the property indicated that the coal seam on the property actually varied in thickness from 12 inches to 60 inches. Variations in the coal thickness made it difficult to establish a mining plan and existing technology did not permit efficient mining of coal seams as thin as 12 inches. In fact, among the reasons why the contract miner ceased mining operations in 1980 was that the coal seam quickly reduced in size from more than 60 inches to less than 20 inches, making it impossible to mine marketable coal.

The confidential offering memorandum dated November 12, 1976, by which interests were offered to various limited partners, recognized that there were numerous risks which could jeopardize the profitability of the venture:

RISK FACTORS

This offer and offerings of many mining investments involve significant risks and should be carefully analyzed by each prospective investor.

1. The economic viability of the Partnership depends upon its being able to obtain a substantial income generated by others who will actually conduct the mining operations on the Coal Properties. An important factor in determining the amount that third parties will be willing to pay will be the market price available on the sale of the coal. In the absence of long term contracts the spot market for coal will govern this market price and at the present time the spot market for the coal is depressed and there can be no assurances that there will be increases in such market price. Therefore, unless the market price for coal increases, profits may not be made by the Partnership and the economic viability of this Partnership is predicated upon the expectation that coal prices will increase. * * *

2. In order to maintain its interest in the Coal Properties, the Partnership must meet a payment schedule of cash minimum royalties. If sufficient capital is not raised to meet these minimum royalty payments or if production and sale of coal is not obtained so that the minimum royalty payments can be met out of earned tonnage royalties, the Partnership could lose its entire interest in the Coal Properties. In addition, if sufficient income is not being generated by mining operations to meet the note payments plus interest to meet the debt service requirements, the Partnership could lose its entire interest in the Coal Properties. (See "NON-RECOURSE NOTE, SECURED PROMISSORY NOTE").

* * * * * * *

4. * * *

On October 29, 1976, the Internal Revenue Service issued a news release concerning advance royalties under coal and mineral leases. The news release stated that a proposed amendment to the income tax regulations modifying the treatment of advanced royalties under Coal leases will be

published in the near future in the Federal Register. The amendment will affect year of deductability [sic] of advanced royalties. Under the amendment to be proposed, the treatment of advanced royalties will be revised effective October 29, 1976, unless advance royalties are required to be paid pursuant to a mineral lease which was binding prior to October 29, 1976, upon the party, who, in fact, paid or accrued such royalties. The news release futher [sic] announces the suspension of Revenue Rulings 70–20 and 74–214. As a result of the suspension of these rulings, taxpayers may not rely upon the tax treatment provided for therein, after October 29, 1976. The news release further contained a proposed amendment to income tax regulation section 1.612–3(b)(b) [sic]. Pursuant to the proposed regulations and the suspension of the aforementioned Revenue Ruling, there can be no assurances that deductions taken by the partnership herein for the payment of coal mining royalties in advance will be allowed by the Internal Revenue Service. In effect, the regulation, if adopted, as proposed, would deny in magnitude the "up front" deduction for coal and other mineral lease arrangements entered into after October 29, 1976. Each investor should carefully consider this matter and in this connection, each investor is urged to consult his own tax advisor as to the efficacy of the Internal Revenue Service's recent action.

* * * * * * *

9. *Environmental and Pollution Controls*

The Partnership will be subject to increasingly strict Federal and State environmental and pollution controls involving its mining operations. Although not now predictable, such controls could possibly entail large capital expenditures, curtailment of production, increased mining costs and loss of reserves.

* * * * * * *

10. *Weather Interruptions*

The coal operations will be subject to periodic interruptions due to severe weather, mostly in wintertime. * * *

11. *Safety Regulation*

The Partnership will be subject to safety regulations relating, among other matters, to the design and use of mining methods and equipment.

* * * * * * *

12. *Transportation*

The Partnership's production could be severely affected by an industry-wide shortage of trucks or railroad cars to transport coal or strikes affecting such transportation methods. * * *

13. *Existence of Coal*

Although the Partnership has received professional written judgments and estimates indicating the existence of substantial recoverable coal reserves under the Partnership's property, based upon historical and geological data, field inspection, spot core drilling and other factors, there is no assurance as to the quantities of such coal reserves or the exact amount of reserves which are physically and economically recoverable. It is intended that such professional judgments and estimates will be reconfirmed by the independent mining engineer's report prior to the disbursement of the proceeds of this offering to the Seller.

14. *Market Place*

During the past several years the market price of coal has been extremely volatile, rising from a low point in 1973 to a peak in 1974–1975 and having declined since. It is presently anticipated that long-term coal purchase contracts will be sought by the Partnership, however, if these contracts are not forthcoming, the Partnership's coal will be sold at whatever prices are available, from time to time (the "Spot Market"), thereby making the Partnership extremely susceptible to price fluctuations. In this regard, it is intended that a Coal Supply Agreement, shall be assigned to the Partnership as a condition precedent to the closing herein. (See Exhibit E for COAL SUPPLY AGREEMENT to be assigned). In the event that the price at which the Partnership is able to sell its coal is not in excess of the sum of its mining costs, taxes, commissions, royalties, fees, required payments of principal and interest on the Note and other obligations and costs, the Partnership may be unable to meet all of its obligations and the General Partner may determine to stop mining operations. In either event, the Partnership runs the risk that, because of inability to pay the fixed obligations of the Note, the investors may have to forfeit their Units. In such event, the investors may lose their entire investment.

15. *Costs of Mining Operations*

Since the cost of mining can fluctuate, the General Partner, may, pursuant to a Mining Contract to be entered into by the Partnership, determine that it would be uneconomical to commence or continue mining activities.

The Partnership will need to sell coal to be removed from the Property at an *average* price of at least $20 per ton in order to have a break-even after tax cash flow. At this price level, the General Partner may elect to defer mining of the coal from the Property.

16. *Mining Contract*

The Partnership would be adversely affected by its being unable to obtain a reputable mining contractor charging in excess of $15 per ton. The Partnership also may be adversely affected by variations in the specifica-

tions of the coal which it mines, causing it not to be able to meet the specifications of a particular buyer of its coal.

Additionally, labor, trucking, explosives and other expenses may increase beyond present levels due to inflation, labor problems, union problems, local shortages, the impact of a national energy crisis and other factors. Variations in levels of productivity and the need for additional equipment may also affect costs. In addition, costs may increase as a result of the enactment of laws regulating business activities affecting the environment and/or health and safety. There can be no assurance that the Partnership will be able to market its coal at a profit. In the event that it is unable to cover its costs, the Partnership and the investors may suffer adverse financial consequences, including the loss of their investment.

The General Partner has represented he will be able to obtain the services of a mining contractor who will mine at $15.00 per ton compensation. However, there can be no assurance to the Partnership of finding a mining contractor at that contract price other than the representation of the General Partner.

17. *Economic Matters*

The possible imposition of mandatory price controls or allocations of various energy sources, including coal, or other measures could have an adverse effect on the Partnership's operations. It is also possible that a reduction in oil or gas prices may reduce the demand for and the price of coal, thereby making the Partnership's proposed mining activities either less profitable or unprofitable. Since a significant portion of the coal mined in the United States is exported, any adverse economic conditions abroad could have a direct adverse effect on the ability of coal producers, especially smaller entities such as the Partnership, to market its coal. * * *

18. *Operating Hazards*

The Partnership will be involved substantially in deep or underground mining. With this type of mining there are significant operating hazards.

* * * * * * *

21. *Mining Experience*

The General Partner has had no experience in the operation of a coal mining business. However, the General Partner has had significant experience in business affairs. The Partnership has agreed to employ the General Partner as a manager for the purpose of supervising the business operations and rendering advice with respect to the marketing of the Partnership's coal. It should be noted that the General Partner has never previously served as a General Partner in a Limited Partnership under these conditions. (See "GENERAL PARTNER").

* * * * * * *

23. *Competition*

The coal industry is highly competitive and the Partnership will be competing with many other domestic coal producers. Most of its competitors have greater financial resources. In recent years, many of the largest United States coal producers have been acquired by companies in other industries, and a number of domestic steel producers and public utilities have acquired control of coal mines. Also, the larger capital outlays that have become necessary to compete effectively have contributed to the closing or sale of many mines. The Partnership's coal will be competing with hydro-electric power and other fuels, principally, oil, natural gas and, to a lesser extent, nuclear power, in the production of electricity and the manufactur [sic] of steel and other metallurgical products.

* * * * * * *

25. *Non-Payment of Non-Recourse Note*

Non-payment of the Non-Recourse Note may result in the forfeiture of the Partnership's interest in the mining lease.

In addition, the opinion of tax counsel that was attached to the offering memorandum recognized the high risk of a challenge to the TCR venture by the IRS. It provided in pertinent part as follows:

The General Partner has advised the undersigned that the Partnership intends to claim the advanced royalty deduction in accordance with current trade practices in the coal industry notwithstanding the Internal Revenue Service Information Release Number 1687, dated October 29, 1976. *The effect of claiming this deduction will almost certainly cause the Internal Revenue Service to challenge the deductibility of the advanced royalty deduction pursuant to the aforementioned information release.* The undersigned law firm, as part of its fee and compensation received in connection with the organization of the Partnership, and the rendering of the within opinion, has agreed to represent the Partnership before the Internal Revenue Service, with regard to any challenge initiated by the Internal Revenue Service with regard to the Partnership tax return and the items of deduction or claims therein. Said representation shall be provided throughout all administrative levels of the Internal Revenue Service without additional fees other than as provided in the offering circular entitled Tennessee Coal Resources, Ltd., dated November 12, 1976. [Emphasis in original.]

TCR encountered many of the problems that were raised as risk factors in the offering memorandum. Among the problems that arose which affected the mining of coal were (1) engineering problems; (2) cold weather that prevented mining for 3 to 4

months in 1977; (3) flooding; (4) undercapitalization of the contract miner; (5) regulations of environmental and mining agencies; (6) depressed coal prices; and (7) a coal seam that became too thin to mine. The actual amounts of coal that were mined by TCR in 1976 and 1977 were zero and 2,827.8 tons, respectively. TCR breached its coal supply agreement with Carolina Power & Light Co. in 1977. No coal was delivered to such utility after May 1977.

In April 1978, Mr. Edwin Tunick was replaced as general partner by Mr. Brent W. Trump. The operation began to turn around under Mr. Trump's guidance, and increased quantities of coal were mined by TCR after his appointment. Nevertheless, TCR abandoned the lease in 1980.

No payments ever were made by TCR on the $2,350,000 nonrecourse note to Mr. Rowlette that had been assigned to GSA.

On its 1976 income tax return, TCR claimed the following expenses:

Legal fees	$100,000
Travel and office	2,576
Phone	1,060
Total	103,636

The latter two expenses were incurred by the general partner and reimbursed by TCR on December 31, 1976. Respondent, in the statutory notices in these cases, disallowed such expenses on the basis that it has not been established that they represented ordinary and necessary business expenses or were expended for the purpose designated.

On its 1977 return, TCR reported gross income from sales of coal in the amount of $85,393. Respondent determined that such gross income was $122,331, and increased the partnership's gross income accordingly by $36,938.

TCR, on its 1977 return, also claimed $20,207 as amortization of organizational expenses. In 1976, TCR disbursed $88,500 to the general partner for organizational expense and paid $1,035 as a filing fee to the State of Florida. Respondent, in the statutory notices, determined that the full amount of $20,207 claimed as an amortization expense was not allowable for failure to establish that the amounts claimed represented

months in 1977. (3) Handling [illegible]

[illegible]

The [illegible]

[illegible]

On the 1977 [illegible]

[illegible]

[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
Total	[illegible]

The [illegible]

On the 1977 [illegible]

[illegible] on the 1977 [illegible]

organizational expenses which may be amortized in accordance with section 709.

Respondent also disallowed $37,596 of other expenses claimed by TCR on its 1977 return on the basis that TCR had not established that such amounts represented ordinary and necessary business expenses or were expended for the purposes designated. The specific deductions with the amounts claimed, the amounts allowed by respondent, and disallowed by respondent are as follows:

Item	*Claimed*	*Allowed*	*Disallowed*
Interest	$1,824	$807	$1,017
Taxes	74	0	74
Repairs	97	0	97
Contract miner/ cost of sales	84,406	62,828	21,578
Tipple fees	7,009	2,656	4,353
Security expense	1,676	0	1,676
Casual labor	5	0	5
Supplies	1,080	0	1,080
Telephone	2,903	0	2,903
Insurance	1,833	0	1,833
Utilities	496	0	496
Auto and travel	2,125	0	2,125
Bank charges	65	0	65
Dues and subscriptions	98	0	98
Uniforms	37	0	37
Office expense	157	0	157

Petitioners Brent W. and Cheryl A. Trump, on their 1976 income tax return, claimed a miscellaneous deduction in the amount of $1,010 for unreimbursed travel and promotional expenses. Respondent disallowed $678 of that deduction on the basis that the petitioners had not established that amounts in excess of $322 constituted ordinary and necessary business expenses, were expended for the purposes designated, or met the requirements for the deduction set forth in section 274. On their 1977 income tax return, the Trumps claimed a deduction in the amount of $1,238 for travel and entertainment expenses. Respondent disallowed $836 of that deduction on the basis that the petitioners had not established that amounts in excess of $402 constituted ordinary and necessary business

expenses, were expended for the purpose designated, or met the requirements for the deduction set forth in section 274.

Petitioners Wilbur F. and Patricia Helmus claimed on their 1976 income tax return a deduction of $5,192 for employee business expenses. Respondent disallowed $1,341 of that deduction on the basis that the petitioners had not established that amounts in excess of $3,851 were ordinary and necessary business expenses or were expended for the purposes designated. The Helmuses claimed on their 1977 income tax return a deduction of $7,064 for employee business expenses. Respondent disallowed $2,556 of that deduction on the basis that the petitioners had not established that amounts in excess of $4,508 constituted ordinary and necessary business expenses or were expended for the purposes designated.

Petitioner Russell L. Redhouse, Jr., on his 1976 income tax return, reported $2,043.09 income from dividends and claimed a $200 exclusion thereby having added to other income the amount of $1,843.09.[8] Respondent determined that this income was in fact interest income and that, therefore, the $200 exclusion was not allowable. Respondent also determined that the actual interest income was in the amount of $2,053.69 rather than the $2,043.09 reported. Therefore, respondent determined that income for the year 1976 was increased in the amount of $210.60.

Also on his 1976 income tax return, Mr. Redhouse claimed a deduction in the amount of $740 for employee business expenses. Respondent disallowed $553.25 of that deduction on the basis that the petitioners had not established that amounts in excess of $186.75 were allowable under section 274.

OPINION

To outline briefly the salient facts, TCR was formed on December 30, 1976, after petitioners and others agreed to subscribe for limited partnership interests therein. One day later, TCR acquired an ongoing coal mine. The specific assets acquired comprised: a sublease that included rights to mine

coal and to use a tipple; a coal supply agreement with Carolina Power & Light; an operating agreement with Mr. John T. Walden; and a note receivable and a security interest on the sale of mining equipment. In payment for the coal mine, TCR transferred $650,000 cash and gave a nonrecourse note for $2,350,000. TCR characterized the entire amount as an advanced royalty and claimed an advanced royalty deduction in the amount of $3 million on its 1976 return.

Respondent disallowed the entire deduction under section 1.612–3(b)(3), Income Tax Regs., as amended by T.D. 7523, 1978–1 C.B. 192,[9] because no coal was mined in 1976. It is respondent's position that, under the regulation as amended, an advanced lump-sum royalty may be deducted only upon the sale of the coal with respect to which it is paid. Petitioners counter with the argument that the amended version of section 1.612–3(b)(3), Income Tax Regs., is invalid because (1) the Internal Revenue Service failed to comply with the requirements of the Administrative Procedure Act (APA) in promulgating the regulation, and (2) the legislative reenactment doctrine mandates that the prior regulation is the proper interpretation of the Code.

The parties agree on the following relevant facts with respect to the amendment of the regulation at issue. On October 29, 1976, the Internal Revenue Service issued a news release in which it announced that proposed regulations under section 612, that would modify the treatment of advanced

royalties under mineral leases as of October 29, 1976, would be published in the Federal Register during the following week. News Release IR-1687, Oct. 29, 1976. Under the proposed regulations, a copy of which was attached to the press release, lump-sum advanced royalties could be deducted only in the year of sale of the mineral product with respect to which the royalty is paid. The news release also announced that it was suspending Rev. Rul. 70-20, 1970-1 C.B. 144, and Rev. Rul. 74-214, 1974-1 C.B. 148, wherein the Service had concluded that lump-sum royalties were deductible when paid or accrued. On November 2, 1976, a notice of proposed rulemaking, containing the proposed regulation that had been attached to the News Release IR-1687, was published in the Federal Register along with an announcement that public hearings would be held on November 30, 1976. In the November 15, 1976, issue of the Internal Revenue Bulletin, the Service announced that an amendment to section 1.612-3(b)(3), Income Tax Regs., was proposed, that hearings would be held on November 30, 1976, and that the last date for the submission of comment was November 23, 1976. Some 13 months later, on December 19, 1977, T.D. 7523, 1978-1 C.B. 192, was published in the Federal Register (42 Fed. Reg. 63640). The final version of the regulation was substantially the same as that published in News Release IR-1687 and in the Federal Register notice of November 2, 1976,[10] and was to be applied retroactively to October 29, 1976. Also on December 19, 1977, Rev. Rul. 77-489, 1977-2 C.B. 177, announced the revocation of Rev. Rul. 70-20 and Rev. Rul. 74-214.

The first issue raised by petitioners for our consideration is whether, in amending section 1.612-3(b)(3), Income Tax Regs., respondent complied with the procedural requirements of the Administrative Procedure Act (APA) and the requirements in the regulations of the Internal Revenue Code with respect to proposed rulemaking. In addition, we must determine whether the Commissioner abused his discretion in selecting an effective date for the new regulation that made the new regulation retroactive in its application.

Petitioners argue that, in promulgating regulations, the IRS

is bound by the provisions of the Administrative Procedures Act, 5 U.S.C. sec. 551 et seq.,[11] including the requirements of 5 U.S.C. sec. 552(a)(1) concerning publication in the Federal Register of substantive rules of general applicability. As such, petitioners argue that the provisions of 5 U.S.C. sec. 553(d),[12] requiring publication of a substantive rule at least 30 days before its effective date, apply to the IRS and were not complied with in the process of amending section 1.612–3(b)(3), Income Tax Regs.

Respondent admits that the 30-day rule of 5 U.S.C. sec. 553(d) generally is applicable to the Internal Revenue Service. However, respondent argues that to give the provision the literal meaning attributed to it by petitioners would render section 7805(b), which authorizes the Secretary to prescribe the extent, if any, to which any regulation shall be applied without retroactive effect, meaningless. Section 7805 provides:

SEC. 7805. RULES AND REGULATIONS.

(a) AUTHORIZATION.—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) RETROACTIVITY OF REGULATIONS OR RULINGS.—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

Thus, a seeming conflict is created between the Secretary's power to promulgate retroactive regulations and the APA's requirement of 30 days' advance notice before regulations take effect.

Neither the legislative history of 5 U.S.C. sec. 553(d) nor the history of section 7805(b) resolves this apparent conflict. The history of section 7805(b), however, is illuminating in that it

reveals that the section originally was conceived as a way to permit the Secretary of the Treasury to assist taxpayers who were adversely affected by subsequent changes in the regulations. In other words, section 7805(b) was intended to be a taxpayer-relief provision by granting the Internal Revenue Service power to avoid inequitable results by applying its regulations and rulings with prospective effect only. As such, retroactive effect was presumed, and prospective application could only be achieved by specific provision. See H. Rept. 350, 67th Cong., 1st Sess. (1921), 1939-1 C.B. (Part 2) 168; S. Rept. 275, 67th Cong., 1st Sess. (1921), 1939-1 C.B. (Part 2) 181. See also H. Rept. 704, 73d Cong., 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 583 ("in some cases the application of regulations, Treasury decisions, and rulings to past transactions which have been closed by taxpayers in reliance upon existing practice, will work such inequitable results that it is believed desirable to lodge in the Treasury Department the power to avoid these results by applying certain regulations, Treasury decisions, and rulings with prospective effect only").

The legislative history of the APA reveals that the purpose of the 30-day rule of 5 U.S.C. sec. 553(d) was to afford affected persons a reasonable time to prepare for final effectiveness of a rule or to take any action which the issuance of the rule may require. S. Rept. 752, to accompany S. 7 (Pub. L. 404), 79th Cong., 1st Sess. (1945), reprinted in S. Rept. 248, 79th Cong., 2d Sess. 200 (1946); H. Rept. 1980, to accompany S. 7 (Pub. L. 404), 79th Cong., 2d Sess. (1946), reprinted in S. Rept. 248, 79th Cong., 2d Sess. 259 (1946). See also *United States v. Gavrilovic*, 551 F.2d 1099, 1104 n. 9 (8th Cir. 1977). This is to be contrasted with the purposes behind 5 U.S.C. sec. 553(b). The notice requirements of 5 U.S.C. sec. 553(b) provide an opportunity for interested persons to comment on proposed rules and for the agency promulgating the rule to educate itself before making the rule final. See *Texaco v. Federal Power Commission*, 412 F.2d 740, 744 (3d Cir. 1969).[13]

We are of the opinion that section 7805(b) sets out a blanket rule which specifically permits the Commissioner to prescribe prospective effect to regulations which would otherwise have

retroactive application. See *Dixon v. United States*, 381 U.S. 68, 71 (1965); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 184 (1957); *United States v. California Portland Cement Co.*, 413 F.2d 161, 164 (9th Cir. 1969); *Pollack v. Commissioner*, 392 F.2d 409, 411 (5th Cir. 1968). Furthermore, we believe that section 7805(b) does not conflict with the purposes behind 5 U.S.C. sec. 553(d), that the conflict is more apparent than real in the context of the facts before us.

In the instant case, respondent published the notice of proposed rulemaking in the Federal Register on November 2, 1976, in accordance with 5 U.S.C. sec. 553(b). Comments were solicited, and a hearing was scheduled for November 30, 1976. All concerned parties were informed of the intent to make the regulation retroactive to October 29, 1976. During the approximately 13-month lapse between publication and effectiveness, the IRS acted on the advice gathered in the comments and hearing and made minor changes in the text of the proposed regulation. Affected parties, knowing of the intended retroactivity, had the opportunity to prepare for the final publication of the rule. Therefore, we are satisfied that the purposes behind 5 U.S.C. sec. 553(d) were fulfilled.[14]

Furthermore, we do not believe that making the new regulation retroactive to October 29, 1976, was an unreasonable exercise of the Commissioner's powers under section 7805. This case is not one in which taxpayers acted in accordance with a regulation of the IRS, and the regulation subsequently was changed to call their prior actions into question. Here, affected parties were on notice as of October 29, 1976, of the IRS's intention to amend the regulation with respect to the deductibility of advanced royalty payments.[15] In fact, both the opinion of tax counsel and the "risk factors" section of the offering memorandum for TCR establish that the promoters

and investors had actual notice of the fact that the IRS had issued a proposed regulation and were on notice of the intent of the Service to apply the new regulation retroactively. The petitioners herein entered into the transaction with full knowledge that the venture would likely be questioned by the Internal Revenue Service. Accordingly, our sympathy is minimal for petitioners' argument that the Commissioner acted unreasonably and that they were adversely affected by the retroactivity of the new regulation.

Second, petitioners contend that the regulation as amended is invalid because the old regulation was tacitly approved by Congress pursuant to the so-called legislative reenactment doctrine. See generally *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939). Under such doctrine, "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." *Helvering v. Winmill*, 305 U.S. 79, 83 (1938). Petitioners argue that the old regulation had been in effect since 1960 during which time Congress enacted numerous amendments to the Code including a number of changes to the sections concerning depletion. They note that Congress failed to make any changes which affected the regulations under section 612. Further, petitioners claim that they acted in accordance with the interpretation of the old regulation that was embodied in Rev. Rul. 70–20 and Rev. Rul. 74–214.

Respondent answers by denying that the legislative reenactment doctrine applies in the instant case. First, respondent claims that the last congressional action with respect to section 612 occurred in 1954, yet the interpretation of the old regulation, section 1.612–3(b)(3), Income Tax Regs., that permitted the current deduction of advanced lump-sum royalty payments was not enunciated until 1970. See Rev. Rul. 70–20, 1970–1 C.B. 144. As no affirmative congressional reenactment of section 612 has been undertaken since 1970, he argues that the doctrine cannot apply. Alternatively, even if the legislative reenactment doctrine is found to apply, respondent argues that the old regulation did not permit a deduction for any

advanced royalties other than minimum annual royalty payments and that revenue rulings to the contrary[16] were incorrect interpretations of the old regulation.[17] As such, the amendment to the regulation merely constituted a clarification of the prior regulation.

We begin by pointing out that the respondent's revenue rulings are not binding on this Court. In addition, respondent has the power to amend or withdraw a revenue ruling if it is contrary to law. *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 184 (1957). See also *Dixon v. United States*, 381 U.S. 68, 75 (1965). Therefore, the revocation of Rev. Rul. 70–20 and Rev. Rul. 74–214 by the publication on December 19, 1977, of Rev. Rul. 77–489, 1977-2 C.B. 177, was well within the power of respondent. As such, we do not believe that the legislative reenactment doctrine can be applied to bar reasonable amendments to regulations where, as here, the change is made only prospectively from the date of the announcement of the proposed change. See *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. at 116, wherein the Supreme Court applied the doctrine to invalidate a regulation where such regulation was to apply retroactively to periods prior to its promulgation.

Furthermore, as we noted *supra*, the fact that petitioners were aware at the time they entered into the TCR venture of respondent's intent to revoke the revenue rulings makes us unwilling to give any credence to the argument that petitioners acted in reliance on the interpretation of the old regulation embodied in the revenue rulings. See *Manocchio v. Commissioner*, 78 T.C. 989 (1982). In fact, the situation smacks more of

petitioners rushing in to take advantage of respondent before he can finalize his amendment to the regulations.

In addition, we cannot accept the notion that Congress, by its inaction, "legislatively reenacted" the old regulation. Section 612 was incorporated into the 1954 Code, and section 1.612–3(b)(3), Income Tax Regs., initially was promulgated in 1960. T.D. 6446, 1960–1 C.B. 208, 227. The interpretation that such regulation was applicable to advanced lump-sum royalties was not forthcoming until 1970. See Rev. Rul. 70–20, 1970–1 C.B. 144. Clearly, Congress could not have been aware of the regulation until it came into being in 1960, and of the interpretation here in issue until 1970. As section 612 was not amended during this period, and Congress never even undertook an examination of the regulation or the interpretation thereof espoused in the 1970 revenue ruling, we cannot agree that the legislative reenactment doctrine is applicable.

Finally, even if the legislative reenactment doctrine were to apply, we believe that it is not unreasonable to read the old regulation as applying only to advanced minimum annual royalty payments and not to the advanced lump-sum royalties here in issue. Accordingly, respondent properly revoked the two revenue rulings that extended the coverage of the old regulation to the payment of advanced lump-sum royalties and clarified the regulation by his amendments that are embodied in the new regulation. We hold for respondent.

Next, we turn to the second issue raised by the parties: whether the advanced royalty deduction allowable to TCR should be limited to the amount of cash paid by the partnership. Petitioners claim that the nonrecourse note should be treated as an advanced royalty payment and that it should be treated as having economic reality because there was a reasonable expectation that it would be satisfied. To support their claims, they argue that there were sufficient coal reserves and sufficient projected profit per ton of coal to be mined to satisfy the note. Respondent, on the other hand, asserts that any advanced royalty deduction that is permitted to petitioners should be limited to the amount of cash paid because the nonrecourse note is contingent and otherwise lacks economic substance. He alleges that the facts show (1) that payment on the note neither was contemplated by the parties nor was possible considering the projected earnings

and expenses from the mine; (2) that the payment actually was not intended to be for advanced royalty; (3) that there were not sufficient coal reserves to satisfy the note; (4) that the extremely high degree of risk in the venture made payment on the note improbable; (5) that subsequent events confirm the highly contingent nature of the note; and (6) that nonrecourse notes generally are not used in the coal industry.

We have already held that section 1.612–3(b)(3), Income Tax Regs., as amended, is valid; therefore, advanced royalties are deductible in the year of sale that the mineral with respect to which the advanced royalty is paid or accrued is sold. In the case of minerals sold before production, the mineral product is considered to be sold at the time it is produced. The parties have stipulated that no coal was mined in 1976 and that 2,827.8 tons of coal were mined in 1977. As the cash transferred was more than the amount of royalty due on the coal mined and sold in 1977, we need not determine whether the transfer of nonrecourse notes constituted payment of advanced royalty. Suffice it to say that we are convinced that the royalties due on coal actually mined or sold in 1977 did not exceed the portion of the cash paid that was allocable to royalties.[18] Hence, petitioners are entitled to a deduction for said amount.

The third issue presented for our consideration is whether petitioners' partnership bases should include their respective shares of the nonrecourse note. As before, we decline the invitation to address this issue because it is unnecessary to our adjudication of the deficiencies before us. According to section 722, a partner's basis includes the amount of money and adjusted basis of property contributed to the partnership. Section 752(a) treats any increase in a partner's share of partnership liabilities as a constructive contribution to the partnership by that partner, thereby increasing his basis

accordingly. Sec. 1.752–1(e), Income Tax Regs. The evidence indicates that each of the petitioners contributed cash in excess of the amount of partnership deductions that we have determined to be properly allowable. Accordingly, we need not determine whether their bases include their pro rata shares of the nonrecourse note paid by the partnership. See sec. 752(a); sec. 1.752–1(e), Income Tax Regs.

The fourth issue is whether petitioners may deduct in 1976 their pro rata portions of the amount paid by TCR as a legal expense. Petitioners claim that the partnership paid $100,000 to the law firm of DiGuilian, Spellacy, Bernstein, Lyons & Sanders in 1976 and that they are entitled to deduct such payment as a legal fee incurred as an ordinary and necessary business expense. Respondent disallowed the deduction, claiming that the amount was an organizational expense and therefore must be capitalized.[19]

The Tax Reform Act of 1976 added section 709 to the Code which disallows any current deduction for fees paid in connection with the organization and syndication of a partnership. The legislative history to that section makes clear that, for taxable years beginning after December 31, 1975, such fees are to be capitalized in accordance with the rules of law set forth in Rev. Rul. 75–214, 1975–1 C.B. 185, and *Cagle v. Commissioner*, 63 T.C. 86 (1974), affd. 539 F.2d 409 (5th Cir. 1976). The committee reports also emphasize that partnerships are to be treated like other types of taxpayers for the purpose of characterizing expenditures as capital expenditures or deductible items. See H. Rept. 94–658 (1975), 1976–3 C.B. (Vol. 2) 695, 813; S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 93–94; H. Rept. 94–1515, to accompany H.R. 10612 (Pub. L. 94–455), 94th Cong., 2d Sess. 421 (1976). See also *Kimmelman v. Commissioner*, 72 T.C. 294, 304 (1979). Accordingly, the same treatment afforded to other taxpayers under section 263 is to

be accorded to partnerships under section 709(a). See secs. 1.263(a)-2 and 1.263(a)-3, Income Tax Regs.[20]

In the instant case, petitioners claimed a deduction in 1976 for $100,000 for legal expenses.[21] Petitioners have the burden of proving that the fee accrued by the partnership was currently deductible. Rule 142(a), Tax Court Rules of Practice and Procedure; *Welch v. Helvering*, 290 U.S. 111 (1933). To the extent that the legal fees relate to organizational or selling expenses of the partnership, they are not currently deductible. Secs. 263, 709(a).[22] In determining whether such fees were an ordinary and necessary business expense or a capital expenditure, we must look to the nature of the services performed by Mr. Bernstein and the law firm.[23]

The evidence presented in this case does not show precisely what services were performed by the law firm in exchange for the fee. What is clear is that the firm performed all of the legal work involved in preparing the documentation for the partnership, including drafting the offering memorandum and the tax opinion. Thus, we are convinced that some portion of the fee was for legal services. As we are also convinced that Congress intended section 709 to parallel the treatment provided for organizational expenses in sections 263 and 248, we find that

the portion of the fee attributable to legal advice must be capitalized.[24]

The remaining portion of the fee was for tax advice, for which petitioners arguably may be entitled to a deduction under section 212(3). However, petitioners have not provided us with any evidence to support an allocation of the fee between the legal work and the tax work performed for the partnership. Therefore, in light of petitioners' total failure to prove what portion, if any, of the fee is deductible, we hold for respondent and conclude that the entire amount must be capitalized. See *Wildman v. Commissioner*, 78 T.C. 943 (1982). In doing so, we express no opinion here as to whether fees, that are paid by a partnership and are expressly designated and proved as having been paid for tax advice, are deductible under section 212(3). We note only that the $100,000 fee here at issue was for a wide range of legal work that was integral to the formation of the partnership and its ability to obtain investors. As we have been presented no evidence to ascertain whether any amount was attributable to tax advice aside from the partnership formation advice, we need not reach the issue of whether section 709 overrides section 212(3) with respect to any portion of the fee paid for tax advice.

Finally with respect to the miscellaneous issues raised by respondent relative to the 1976 and 1977 tax returns of TCR and certain individual petitioners, the burden of proof is on petitioners to prove the amount of their income and their entitlement to the claimed deductions. *Welch v. Helvering*, 290 U.S. 111 (1933). Petitioners neither presented any evidence at trial with respect to these miscellaneous adjustments nor argued the propriety of their reporting positions on brief. The only reference to the miscellaneous issues was a statement that they should be considered separately from the issues presented at trial. We hold that the issues were properly

raised by respondent and that petitioners have failed to carry their burden of proof.

In light of the foregoing,

Decisions will be entered under Rule 155.

FOOTNOTES

1. Cases of the following petitioners are consolidated herewith: Irwin M. Adler and Helene E. Adler, docket No. 5709-80; Brent W. Trump and Cheryl A. Trump, docket No. 5710-80; Ronald Glassman and Lenora Rae Glassman, docket No. 5711-80; Stephen L. Nemerofsky and Nina B. Nemerofsky, docket No. 5712-80; Gerald L. Gunderson and Judith C. Gunderson, docket No. 5769-80; Sherwin Ross and Marlynn Ross, docket No. 5771-80; Roman M. Wenzel and Emily A. Wenzel, docket No. 5772-80; Wilbur F. Helmus, Jr. and Patricia Helmus, docket No. 5773-80; and Russell L. Redhouse, Jr., docket No. 9376-80.

2. The statutory notice in docket No. 9376-80 was dated March 28, 1980.

3. The stipulation erroneously states that investors had to have some portion of their annual gross income taxable at a rate of 30 percent or more. The actual requirement was 50 percent as set forth in the Confidential Offering Memorandum, the Subscription Agreement, and the Investor Questionnaire.

4. While the parties have stipulated that petitioner Robert P. Wendland paid $24,500 to TCR on December 23, 1976, the evidence indicates that he purchased 24 units in the partnership and that $24,000 was received from him by the partnership and deposited in the partnership's bank account. We cannot account for the discrepancy between the stipulated amount and the evidence.

5. A tipple is a facility for crushing and loading coal into railroad cars.

FOOTNOTES

1. Cases of the following petitioners are consolidated herewith: [illegible]

2. The statutory notice [illegible] dated March [illegible], 1980.

3. The [illegible]

4. While the parties have stipulated [illegible]

5. A tipple is a facility for [illegible] coal into railroad cars.

6. Michael J. Padula was the attorney for GSA.

7. The mining agreement with John Walden that was assigned by GSA Corporation to TCR provided guidelines with respect to the price that would be paid to John Walden as contract miner. The agreement provided that Walden was to receive a base price of $15.50 per ton for 12,000 BTU coal; $16.50 per ton for 12,500 BTU coal; and $18.50 per ton for 13,000 BTU coal (quality sufficient to sell at $23.50 to Carolina Power and Light). These amounts, however, were mere guidelines to be adjusted based upon the coal supply contract with Carolina Power and Light Company.

8. The parties stipulated that petitioner Mr. Redhouse reported dividend income of $2,043.09 and claimed a $200 exclusion, resulting in taxable dividend income of $843.09. However, his 1976 income tax return indicates that he accurately reported $1,843.09 of taxable dividend income and we so find.

9. Sec. 1.612-3(b)(3), Income Tax Regs., as amended, provides in part as follows:

Sec. 1.612-3. Depletion; treatment of bonus and advanced royalty.

(b) Advanced royalties.

(3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were

[illegible] Michael J. [illegible] [illegible].

[illegible] The existing agreement with [illegible] was assigned to the [illegible] guidelines with respect to the [illegible]

[illegible]

[illegible]

[illegible]

[illegible] Selected Facilities.

[illegible]

paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount.***

10. Minor changes in the content of the regulation between the proposed and final drafts are not relevant here.

11. See sec. 601.601(a)(2), Statement of Procedural Rules.

12. 5 U.S.C. sec. 553(d) provides as follows:

Section. 553. Rule Making.

(d) The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except--
(1) a substantive rule which grants or

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

recognizes an exception or relieves a restriction;
(2) interpretative rules and statements of policy; or
(3) as otherwise provided by the agency for good cause found and published with the rule.

13. See also National Labor Relations Board vs. Wyman-Gordon Co., 394 U.S. 759, 764 (1969).

14. Mere technical violations of the APA will not be considered cause to invalidate a regulation. Nader v. Sawhill, 514 F.2d 1064 (D.C. Cir. 1975); Gulf Oil Corp. vs. Hickel, 435 F.2d 440 (D.C. Cir. 1970).

15. We need not, and do not, determine whether News Release IR-1687 of Oct. 29, 1976 constituted adequate notice of a proposed change such that retroactivity to that date was reasonable. Suffice it to say that the notice of proposed rule making, which clearly constituted adequate notice, was published in the Federal Register on November 2, 1976, almost 8 weeks prior to the formation of the partnership and the transfer of payments in question herein.

16. See Rev. Rul. 74-214, 1974-1 C.B. 148 (lump-sum payment made to lessor in advance of mining and subject to recoupment at a specified rate per ton against coal mined in future is an advanced royalty under sec. 1.612-3(b), Income Tax Regs.); Rev. Rule 70-20, 1970-1 C.B. 144 (lump-sum payments made to lessor at beginning of each of first 9 years of a mineral lease and which are recoupable out of royalties based on

[illegible] in [illegible] of [illegible] a [illegible];
(3) interpretative rules and statements of policy; or
(4) as otherwise provided by the agency for good cause found — and published with the rule.

11. See also National Labor Relations Board v. Wyman-Gordon Co., 394 U.S. 759, 764 (1969).

12. There [illegible] violations of the APA [illegible] not be considered cause to invalidate a regulation. [illegible]

13. We read both, and do not, [illegible] [illegible] notice, of a proposed change [illegible] opportunity [illegible] [illegible] of proposed rule making, [illegible] notice, was published in the Federal Register of November 4, 1976, almost 8 weeks prior to the [illegible]

14. See Fed. Reg. [illegible], 1979 [illegible]

production over the life of the lease were advanced royalties under sec. 1.612-3(b)(3), Income Tax Regs.).

17. Respondent points out that the language of sec. 1.612-3(b)(1), Income Tax Regs., refers to royalties paid by the owner of an operating interest in a mineral deposit "on a specified number of units of such mineral*** annually whether or not extracted." The language of sec. 612-3(b)(3), Income Tax Regs., prior to its amendment referred to the treatment by the payor of advanced royalties "so paid or accrued." It is alleged that the "so paid or accrued" language referred to the type of minimum annual royalty denoted in sec. 1.612-3(b)(1), Income Tax Regs., and specifically referred to in the example in sec. 1.612-3(b) (4), Income Tax Regs. See also Commissioner v. Jamison Coal & Coke Co., 67 F.2d 342 (3d Cir. 1933); Burnet vs. Hutchinson Coal Co., 64 F.2d 275 (4th Cir. 1933); T.D. 4960, 1940-1 C.B. 38.

18. Respondent argued on brief that the nonrecourse note should be disregarded, the cash should be allocated to each of the assets acquired in the transaction, and the advance royalty payment should be limited to the remainder of the cash transferred. We agree with respondent that a package of valuable assets was acquired, including mining rights, rights to use a tipple, coal supply agreement, an operating agreement, a note receivable on the sale of equipment, and an ongoing mining operation. However, we believe that a portion of the payment was for payment of advanced royalties. As we are convinced that the amount paid for advanced royalties exceeded the amount of royalty

[illegible]

[illegible]

[illegible]

deduction to which petitioners are entitled for 1977, we need not determine the precise allocation.

19. In 1976, when the disputed expense was incurred, organization and syndication expenses were required to be capitalized. See sec. 709(a) (effective for taxable years beginning after Dec. 31, 1975). Sec. 709(b), which permits the amortization of partnership organizational expenses over a 60-month period, applies only to taxable years beginning after Dec. 31, 1976. Thus, if we hold for respondent, the amortization provisions of sec. 709(b) will not be available to petitioners. Tax Reform Act of 1976, sec. 213(f) (1), (3), 90 Stat. 1548-1549. See also S. Rept. No. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 94-95.

20. The legislative history also reveals that the provision in sec. 709(b) for amortization of organizational expenses incurred in taxable years beginning after Dec. 31, 1976 was intended to parallel the election available under sec. 248 for amortization of organizational expenditures of a corporation.

21. Petitioners have not submitted any proof that they actually paid the amount claimed as a deduction for legal expenses in 1976. The only indication that there existed any obligation to pay was the statement in the offering memorandum that payment of a $100,000 "fee to attorneys for organization, structure and tax opinion to the partnership" was expected to be made. However, respondent does not deny that the $100,000 properly was accrued by the accrual basis partnership. He

amounts to which petitioners are entitled
for 1973, we need not determine the precise
allocation.

56. In 1973, when the disputed expenses were incurred, organization and reorganization expenses were required to be capitalized. [illegible] Sec. 709(a) (effective for taxable years beginning after Dec. 31, 1975). Sec. 709(b) which permits the amortization of partnership organizational expenses over a 60-month period, applied only to taxable years beginning after Dec. 31, 1976. [illegible]

57. [illegible]

58. [illegible]

only claims that such amount should have been capitalized. We, therefore, consider respondent to have conceded the fact that the payment properly was accrued, and we proceed to a consideration of the characterization of the expense as a capital or a currently deductible item.

22. See also Bush Terminal Buildings Co. vs. Commissioner, 7 T.C. 793, 819 (1946); Wolkowitz v. Commissioner, a Memorandum Opinion of the Court dated Aug. 25, 1949.

23. The evidence shows that Mr. Bernstein, in conjuction with Mr. Edwin Tunick, developed the idea of forming TCR. Mr. Bernstein knew of a number of potential mines for TCR's acquisition and traveled with Mr. Tunick to look at the mines and their assets. For these services, the offering memorandum provided that Mr. Bernstein's law firm was to receive $1 per ton of coal mined in lieu of any finder's fee. Thus, we believe that the $100,000 fee was not intended to be payment for services which were so otherwise compensated.

24. The IRS has issued proposed regulations, sec. 1.709-2 (a), (b) wherein organizational expenses are defined specifically to include "[l]egal fees for services incident to organization of the partnership, such as negotiation and preparation of a partnership agreement," and syndication expenses include "expenses connected with the issuing and marketing of interests in the partnership," such as "legal fees of the underwriter or placement agent and the issuer *** for securities advice and for tax advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum;

only placed that such security should have been [illegible]. [illegible] Moreover [illegible] in fact that the payment properly was obtained, and so [illegible] to a consideration of the [illegible]

[illegible]

[illegible]

accounting fees for preparation of representations to be included in the offering materials; ***."

We voice no opinion with respect to the validity of such regulations.

UNITED STATES TAX COURT

RUSSELL L. REDHOUSE, JR.,	)	
Petitioner,	)	
v.	)	Docket No.: 9376-80
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed August 23, 1982, and incorporating herein the facts recited in the respondent's computation of the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1976 in the amount of $12,351.32.

Judge Sterrett

Entered: Mar. 17, 1983

No. 84-104 (3)

In the Supreme Court of the United States

OCTOBER TERM, 1984

RUSSELL REDHOUSE, JR., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

GARY R. ALLEN
BRUCE R. ELLISEN
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

1988

QUESTIONS PRESENTED

1. Whether a 1977 amendment to Section 1.612-3(b)(3) of the Treasury Regulations on Income Tax is invalid under the Administrative Procedure Act because the amendment was not published in the Federal Register in final form 30 days before its designated effective date.

2. Whether the Commissioner abused his discretion under Section 7805(b) of the Internal Revenue Code by making the amendment described above retroactive to October 29, 1976, the date on which the proposed amendment was publicly announced.

3. Whether the Tax Court has jurisdiction to rule on objections to the validity of Treasury Regulations where such objections are based on provisions of the Administrative Procedure Act.

TABLE CONTENTS

TABLE OF AUTHORITIES

Cases:

Page

Cases—Continued:

Page

Miscellaneous:

In the Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-104

RUSSELL REDHOUSE, JR., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-21) is reported at 728 F.2d 1249. The opinion of the Tax Court (Pet. App. 24-67) is reported at 79 T.C. 355.

JURISDICTION

The judgment of the court of appeals was entered on March 20, 1984. The petition for a writ of certiorari was filed on July 18, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner is a limited partner in a partnership known as Tennessee Coal Resources, Ltd. (TCR). The partnership was formed on December 30, 1976 (Pet. App. 1-2). On December 31, 1976, TCR acquired a lease interest in a coal mine by transferring $650,000 in cash and a $2,350,000 nonrecourse note to the lessor of the mine (*id.* at 2-3). TCR

mined no coal during 1976 (*id.* at 3). TCR characterized the entire $3 million payment as a lump-sum advance royalty and claimed a deduction in that amount on its 1976 partnership income tax return. Petitioner reported his pro rata share of that deduction on his individual tax return for 1976 (*ibid.*).

Petitioner acquired his TCR limited partnership interest as a result of an offering memorandum dated November 12, 1976 (Pet. App. 12). That memorandum referred to a news release issued by the Internal Revenue Service on October 29, 1976, announcing a proposed amendment to Treas. Reg. § 1.612-3(b)(3), which governs the tax treatment of advance royalties (Pet. App. 39-40). Under the proposed amendment, published in the Federal Register on November 2, 1976 (41 Fed. Reg. 48133), advance royalties generally were to be deductible by the payor only in the year of sale of the mineral with respect to which the royalty had been paid. The news release also announced the temporary suspension of Rev. Rul. 70-20, 1970-1 C.B. 144, and of Rev. Rul. 74-214, 1974-1 C.B. 148, which had indicated that mineral royalties could generally be deducted in the year in which paid or accrued (Pet. App. 47-48). The news release specifically stated that the proposed amendment to the regulation, if adopted, would apply to all leases entered into on or after the date of the announcement, that is, on or after October 29, 1976 (*ibid.*). The TCR offering memorandum specifically warned potential investors of the risk that the Commissioner, on the basis of the amended regulation, would challenge TCR's deduction of the advance royalty that TCR planned to pay (and did pay) on December 31, 1976 (*id.* at 2, 12, 39-40). The opinion of tax counsel, attached to the offering memorandum, advised that the IRS "will almost certainly * * * challenge the deductibility of the advanced royalty" (*id.* at 43).

A public hearing on the proposed amendment to the regulation, following solicitation and receipt of public comments, was held on November 30, 1976 (Pet. App. 4). The final version of the amendment, which was substantially similar to the proposed version, was published in the Federal Register on December 19, 1977 (42 Fed. Reg. 63640-63641). Accompanying that publication was a statement indicating that the amendment, as previously announced, would be applied to all transactions that became effective on or after October 29, 1976 (*ibid.*) In accordance with the amended regulation, the Commissioner, on audit, disallowed the advance royalty deductions claimed by petitioner and the other TCR limited partners for 1976, since TCR did not produce or sell any coal in that year (Pet. App. 3).

Petitioner sought redetermination of the resulting deficiency in the Tax Court,[1] contending that the retroactive application of the amendment to Treas. Reg. § 1.612-3(b)(3) was impermissible. He argued that the amendment's retroactive application violated the Administrative Procedure Act (APA) and that Congress had legislatively reenacted the earlier version of the regulation (Pet. App. 47-54).[2] The Tax Court rejected those arguments and sustained the asserted deficiency, without reaching the Commissioner's alternative contention that TCR's execution of the $2.35 million nonrecourse note did not constitute sufficient payment to support the claimed deduction in any event (*id.* at 54-55).

[1]The Tax Court consolidated petitioner's case with cases involving nine other TCR partners. They appealed the Tax Court's adverse decisions to the Eleventh Circuit, which affirmed. *Wendland* v. *Commissioner,* 739 F.2d 580 (1984).

[2]Petitioner did not otherwise contest the correctness of the rule set forth in the amended regulation.

The court of appeals unanimously affirmed, holding that the Secretary of the Treasury did not abuse his discretion in applying the amended regulation retroactively to transactions entered into after October 29, 1976, the date the proposed amendment was publicly announced (Pet. App. 5-13). The 1977 amendment, the court observed, did not change settled law, since the prior version of the regulation had permitted deduction only of *annual* advance royalties, without referring to the deductibility of *lump-sum* advance royalties of the sort involved here (*id.* at 6-7). It was not until 1974, the court noted, that the Commissioner, in Rev. Rul. 74-214, interpreted the regulation to permit deduction of such lump-sum payments. The court concluded that Congress could not be said to have approved, explicitly or implicitly, the interpretation set forth in Rev. Rul. 74-214, because there had been no change in the underlying statute since 1974 (Pet. App. 10-11). And the court held that retroactive application of the amended regulation would not be unduly harsh to petitioner, since he had ample notice of the proposed amendment before he acquired his TCR limited partnership interest (*id.* at 12-13).

The court of appeals likewise rejected petitioner's contention that the amendment's retroactive application was contrary to a provision of the Administrative Procedure Act, 5 U.S.C. 553(d), which generally requires that a "substantive rule" be published in the Federal Register 30 days before its effective date. The court concluded that Section 7805(b) of the Internal Revenue Code, which grants the Secretary broad discretion to apply tax regulations retroactively, controls over Section 553(d), which concerns the rulemaking power of admininistrative agencies generally (Pet. App. 13-15). And the court held in the alternative that Section 553(d) would not apply here in any event, since the amendment in question was not a "substantive rule" but an "interpretative rule" exempt from the APA's effective date provisions under 5 U.S.C. 553(d)(2) (Pet. App. 15-16).

Finally, the court rejected petitioner's argument that the Tax Court lacked subject matter jurisdiction to decide whether the amended regulation had been promulgated in compliance with the APA. The court of appeals reasoned that the Tax Court was properly constituted as an Article I court and that its jurisdiction to determine the correct amount of petitioner's tax necessarily encompassed the power to determine the validity and applicability of the regulation under which the deficiency in tax had been asserted (Pet. App. 16-17, 19-21 n.2).

ARGUMENT

The decision below is correct. Contrary to petitioner's contention, there is no conflict among the circuits on any of the questions presented. Indeed, the decision below is fully in accord with the only other appellate decision on point, *Wendland* v. *Commissioner,* 739 F.2d 580 (11th Cir. 1984), which arose out of the same transaction and presented identical issues, and which expressly followed the reasoning and result of the court of appeals here.

1. Section 7805(b) of the Code[3] provides that the Secretary "may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect." This Court and the courts of appeals have uniformly interpreted Section 7805(b) and its predecessors to mean that tax regulations are presumptively retroactive, and that the Commissioner's election not to remove that retroactive feature is reviewable only for abuse of discretion. *Dixon* v. *United States,* 381 U.S. 68, 72-76 (1965); *Automobile Club* v. *Commissioner,* 353 U.S. 180, 183-184 (1957); *Wilson* v. *United States,* 588 F.2d 1168, 1171-1172 (6th Cir. 1978); *Anderson, Clayton & Co.* v. *United States,* 562 F.2d 972, 980-981 (5th Cir. 1977),

---

[3]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

cert. denied, 436 U.S. 944 (1978); *Jones* v. *United States*, 553 F.2d 667, 670 (Ct. Cl. 1977). See *Dickman* v. *Commissioner*, No. 82-1041 (Feb. 22, 1984), slip op. 12-13 ("[I]t is well established that the Commissioner may change an earlier interpretation of the law, even if such a change is made retroactive in effect.").

Petitioner, however, argues (Pet. 9-26) that the IRS's power to promulgate retroactive regulations is limited by the Administrative Procedure Act, which generally requires (5 U.S.C. 553(d)) that a "substantive rule" be published in the Federal Register not less than 30 days before its effective date. Specifically, petitioner contends that the 1977 amendment to Treas. Reg. § 1.612-3(b)(3) cannot be applied in this case because it was not approved and published in final form until December 1977, eleven months after TCR made its lump-sum advance royalty payment.

The court of appeals properly rejected petitioner's argument on two independent grounds. First, Section 7805(b) is a specific statute giving the Secretary broad discretion to apply tax regulations retroactively. Section 553(d) of the APA, by contrast, is a generalized statute governing rule-making by all federal administrative agencies. It is elementary that a specific statute controls over a general one. *Morton* v. *Mancari*, 417 U.S. 535, 550-551 (1974); *Bulova Watch Co.* v. *United States*, 365 U.S. 753, 758 (1961). The court of appeals thus correctly held (Pet. App. 15) that Section 7805(b) takes precedence over the general provisions of 5 U.S.C. 553(d).[4]

---

[4]Petitioner's contention (Pet. 14-15, 49) that the decision below conflicts in this respect with *Rowell* v. *Andrus*, 631 F.2d 699, 701 (10th Cir. 1980), and with *United States* v. *Gavrilovic*, 551 F.2d 1099, 1104 n.9 (8th Cir. 1977), is frivolous. Those cases, involving regulations respectively promulgated by the Interior Department and the Drug Enforcement Agency, did not involve the application of Section 7805(b) of the Internal Revenue Code or of any analogous statutory provision. Indeed,

Second, even if we were to assume that the APA's 30-day notice requirement inhibits the Commissioner's authority to promulgate retroactive tax regulations, the court of appeals properly concluded (Pet. App. 15-16) that the amendment at issue here is an "interpretative rule" and as such would be excepted from that requirement under 5 U.S.C. 553(d)(2). As the court below noted (Pet. App. 16), in contrast to the situation here, Section 611(a) of the Code directs the Secretary to prescribe regulations concerning the determination of a "reasonable allowance for [mineral] depletion." Regulations pertaining to mineral depletion and promulgated pursuant to that statutory authorization would thus arguably be "legislative regulations"[5] and hence "substantive rules" within the meaning of APA Section

---

the court below was the first court of appeals to consider whether Section 553(d) of the APA limits the Secretary's discretion under Section 7805(b) to issue tax regulations having retroactive effect. The only court of appeals that has considered that question subsequently —the Eleventh Circuit in *Wendland, supra* — specifically adopted both the reasoning and the result of the court of appeals here.

[5]In the federal tax context, regulations issued pursuant to a specific statutory delegation of authority, whereby the Commissioner is directed to prescribe a detailed set of rules to implement a particular section of the Code, are considered "legislative" in character. See, *e.g.*, I.R.C. § 1502 ("The Secretary shall prescribe such regulations as he may deem necessary" to implement the right of affiliated corporations to file a consolidated tax return). Legislative regulations generally have the force and effect of law so long as they are within the scope of the statutory delegation. "Interpretative regulations," issued under the Commissioner's general authority to interpret and clarify the Code, are also entitled to great weight in construing the statute, although to somewhat less weight than legislative regulations. See, *e.g.*, *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981). The provisions of Section 7805(b), granting the Commissioner discretionary authority to prescribe the retroactive effect of tax regulations, have been held applicable to legislative as well as to interpretative regulations, and the courts have looked to the same factors in determining whether the Commissioner abused his discretion in making either sort of regulation retroactive. *E.g.*, *Anderson, Clayton & Co.*, 562 F.2d at 984.

553(d). The regulation at issue here, however, was promulgated under Section 612 of the Code and concerns, not mineral depletion, but the allowance of a deduction for royalty payments as an ordinary and necessary business expense (I.R.C. § 162) or as an expense for the production of income (I.R.C. § 212). This regulation was not issued pursuant to any specific delegation of legislative authority, but pursuant to the Commissioner's general authority under Code Section 7805(a) to prescribe "all needful rules and regulations for the enforcement of" the Internal Revenue Code.[6] The 1977 amendment to the regulation, moreover, served only to clarify its predecessor's ambiguous provisions respecting the deduction of advance royalties. See page 9, *infra*. Thus, as the court of appeals concluded (Pet. App. 16), the amendment at issue is an "interpretative rule" to which the APA's 30-day notice provision would not apply.[7]

2. Petitioner's assertion that the decision below grants the Commissioner "unlimited authority to apply treasury regulations retroactively" (Pet. 26, 27-39) is specious. The court of appeals clearly recognized (Pet. App. 5-6) that the Commissioner's decision to apply a regulation retroactively "is review[able] for an abuse of discretion." The court concluded that the Commissioner did not abuse his discretion

---

[6]The Treasury Decisions proposing and adopting the challenged amendment to Treas. Reg. § 1.612-3(b)(3) list Section 7805(a) as the sole authority for its promulgation. See 41 Fed. Reg. 48133 (1976); 42 Fed. Reg. 63640-63641 (1977).

[7]Petitioner errs in contending (Pet. 17-18) that the decision below, insofar as it treats the amendment to Treas. Reg. § 1.612-3(b)(3) as an "interpretative rule," conflicts with *Green* v. *United States*, 460 F.2d 412 (5th Cir. 1972). That case involved an entirely different regulation (Treas. Reg. § 1.611-2(d), governing determination of the fair market value of certain mineral property), and the Fifth Circuit did not state whether that regulation should be considered legislative or interpretative in character. See 460 F.2d at 417 n.4.

here because (1) the 1977 amendment did not change settled law, (2) the particular interpretation of the unamended regulation upon which petitioner relied had never been approved by Congress, and (3) retroactive application to petitioner of the amended regulation would not produce a harsh result (Pet. App. 6-13). These factors are the same as those used by other courts of appeals in determining whether a tax regulation's retroactive application constitutes an abuse of discretion. See, *e.g.*, *Anderson, Clayton & Co.*, 562 F.2d at 981; *Wilson*, 588 F.2d at 1171-1172; *Chock Full O'Nuts Corp.* v. *United States*, 453 F.2d 300, 302-303 n.6 (2d Cir. 1971).

This Court has occasionally declined to give retroactive effect to a regulation that changes settled law (see *Helvering* v. *R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939)), but the 1977 amendment to Treas. Reg. § 1.612-3(b)(3) plainly did not do that. As the court below observed (Pet. App. 7), the unamended version of the regulation permitted the deduction of *annual* advance royalty payments, but did not specifically address the question whether a single, lump-sum payment of the sort involved here would be deductible in the year paid. Thus, the language of the former regulation itself did not provide any secure foundation for the deduction petitioner claimed, and it was not until 1974 that the Commissioner, in Rev. Rul. 74-214, *supra*, interpreted the regulation to allow immediate deduction of lump-sum advance royalties.[8] Just two years later, that ruling was suspended and the proposed amendment was published. Under such circumstances, the interpretation of the regulation advanced in Rev. Rul. 74-214 hardly constituted such

---

[8]The other revenue ruling suspended by the IRS's October 29, 1976, announcement, Rev. Rul. 70-20, *supra*, dealt with the deductibility of minimum royalty payments required over the first nine years of a lease, and thus could not have served as a basis for deducting a single, lump-sum royalty like that involved here.

"settled law" as to preclude suspension of the ruling and application of the amended regulation to transactions entered into after the proposed amendment was publicly announced. See *Dixon*, 381 U.S. at 72-76 (holding that the Commissioner is entitled to withdraw erroneous rulings retroactively even where taxpayers have relied detrimentally on them).

By the same token, petitioner errs in contending (Pet. 32-35) that Congress implicitly approved the interpretation of the regulation set forth in Rev. Rul. 74-214. As the court of appeals noted (Pet. App. 11), that ruling was the first and only administrative pronouncement that authorized the immediate deduction of a lump-sum advance royalty, and "it cannot be said that Congress approved [that] ruling because there was no change in the pertinent underlying statutory law since 1974."

Finally, petitioner's assertion that a regulation may not be applied retroactively "where its application would be against the interest of the taxpayer" (Pet. 36) is simply wrong. Retroactive application of regulations is often against the interest of the taxpayer, but, as the court of appeals observed (Pet. App. 12), the Commissioner is precluded from giving regulations retroactive effect only in those rare situations where "the result would be unduly harsh to a particular taxpayer." See *Anderson, Clayton & Co.*, 562 F.2d at 981. Application of the amended regulation to petitioner cannot possibly be judged "unduly harsh," since the November 12, 1976, offering memorandum on which he relied in making his limited partnership investment specifically warned him that the IRS had proposed to amend the regulation, that the amendment would apply to all leases entered into on or after October 29, 1976, and that the IRS on the basis of that amendment would "almost

certainly * * * challenge the deductibility of the advanced royalty" that TCR planned to pay (Pet. App. 43).[9]

3. Petitioner's final contention — that the Tax Court lacks jurisdiction to consider "constitutional issues related to the determination of a Federal tax deficiency" (Pet. 39) — is also meritless. The Tax Court, to begin with, did not consider any constitutional questions in this case (see Pet. App. 46-54). Petitioner's real complaint seems to be that the Tax Court, as an Article I court, lacks jurisdiction "to review compliance of a regulation in accordance with the APA" (Pet. 40). The question whether a regulation complies with the Administrative Procedure Act, however, is not a constitutional question. In any event, the court of appeals was plainly correct in holding (Pet. App. 17-18, 19-21 n.2) that the Tax Court had jurisdiction to consider the validity of Treas. Reg. § 1.612-3(b)(3).

As the court below noted (Pet. App. 17), the Tax Court is a legislative court properly established under Article I of the Constitution (I.R.C. § 7441) and expressly empowered by Congress to determine the correct amount of an asserted deficiency in tax (I.R.C. §§ 6214(a), 7442). The Tax Court thus necessarily has the power to consider the validity of a regulation on which the Commissioner relies in asserting a deficiency, and its jurisdiction to consider the validity of

[9]Petitioner likewise errs in asserting (Pet. 36-38) that retroactive application "would result in disparative [sic] treatment between similarly situated taxpayers." To the contrary, all transactions entered into on or after October 29, 1976, are treated in precisely the same way. The Commissioner's choice of October 29, 1976, as the effective date was reasonable, because that is the day on which the proposed amendment was publicly announced. See *United States* v. *Darusmont*, 449 U.S. 292 (1981). Taxpayers who entered into such transactions after October 29, 1976, obviously, are not "similarly situated" with respect to taxpayers who became obligated to pay advance royalties under agreements signed before the proposed amendment was made public.

such a regulation cannot logically be affected by the statutory origin (be it the Administrative Procedure Act or the Internal Revenue Code) of the taxpayer's challenge. Indeed, if the Tax Court could not have considered petitioner's challenge to the validity of the amended regulation, it would follow that the court would have been bound to sustain the Commissioner's asserted deficiency without regard to the merits of petitioner's contentions.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

GARY R. ALLEN
BRUCE R. ELLISEN
Attorneys

OCTOBER 1984

DOJ-1984-10